suite101.com
The genuine article. Literally.

Merriman interview with John Bogle

Author: **bob90245**
Date: **Apr 3, 2004**

http://www.suite101.com/discussion.cfm/i...

John Bogle
Author: pbradford6
Date: March 31, 2004

This is an interesting article suggesting that the Vanguard Total Stock Market Index fund may not be what it purports to be.

PAUL MERRIMAN

Where's the 'total' in Vanguard fund?
Short shrift for small caps in Total Stock Market portfolio

By Paul Merriman, CBS.MarketWatch.com
Last Update: 12:02 AM ET March 31, 2004

SEATTLE (CBS.MW) -- John Bogle, founder and retired chairman at Vanguard Group, has done a great deal for individual investors over the past 30 years.

Back in the 1970s, Bogle pioneered index funds and no-load mutual funds, and his actions put pressure on many other fund families to keep costs low and offer no-load funds. I think it's safe to say that because of John Bogle, individual investors have kept billions of dollars that would otherwise have been eaten away by the investment industry.

Vanguard remains true to Bogle's vision of keeping costs down and shareholders in the driver's seat. And you haven't found Vanguard implicated in any of the mutual fund scandals of the past six months.

Nevertheless, Bogle does appear to have a blind spot -- or at least it's fair to say he and I disagree on one very fundamental premise: wide diversification is in the best interests of investors.

I was asked about this in a message from Donald in Connecticut, who had listened to a recent radio show interview I had with Bogle. In the interview, I challenged Bogle on his tireless promotion of the Vanguard Total Stock Market Index Fund (VTSMX: news, chart, profile) as essentially the only investment vehicle investors need.

Donald wrote: "How can a person of John Bogle's knowledge and experience believe that the Total Market Index Fund has enough small-cap representation to give the average investor the correct equity diversification?"

Donald pointed out that the Total Stock Market Fund is about 65 percent invested in large-cap companies, 25 percent in mid-cap companies and 9 percent in small-cap companies. Actually, Morningstar breaks it down this way: giant companies, 40 percent; large companies, 30 percent; medium companies, 20 percent; small companies, 7 percent; and micro-cap companies, 2 percent.

My own recommendation, based on market returns that go back nearly 80 years, is that investors split their U.S. equity investments equally, having half in large-cap funds and half in micro-cap funds. By that standard, John Bogle's favorite fund has far too much large-cap exposure and far too little small-cap exposure.

In answer to Donald, I can say only that while I admire Bogle immensely, his attitude seems to be that he believes what he believes, and that is essentially the end of the story.

When I interviewed John, we talked about value funds, which over the years have generated returns of 2 to 5 percentage points per year higher than the Standard & Poor's 500 Index.

Bogle said the Total Stock Market Index Fund "is half value and half growth. You own every value stock in America."

But he then went on to argue against value investing, saying he doesn't think there are many "great value managers out there, and they charge a lot of money" in fees. Even if value stocks were dominant in the past, he said, their popularity has bid up their prices so much that "They won't be dominant in the future."

Bogle apparently believes millions of other investors can't be wrong. He maintains most of his own money in index funds that mimic the composite choices of all other investors.

Bogle doesn't have much use for balancing large with small, dismissing that approach as "other things" that some investors try in order to get ahead. "Work your special strategies at the margin," while keeping 80 percent of your equity investments in the total market index, he said.

When I cited statistics showing how small-cap stocks have out-performed large-cap ones over long periods, Bogle dismissed this. Every comparison of past investment returns pertains only to the specific period chosen for the study, he said. That's true, but it's no reason to ignore the facts.

I doubt that John and I are ever going to agree on this topic, and that's OK. But I think he is leaving money on the table by not using a few of the Vanguard index funds he helped to start.

For years, my firm has recommended that a U.S. equity portfolio be divided equally into four asset classes: large-cap, large-cap value, small-cap and small-cap value. Each of those is represented very well by a Vanguard index fund. (These include the Index 500 (VFINX: news, chart, profile), Value Index (VIVAX: news, chart, profile), Small-Cap Index (NAESX: news, chart, profile) and Small-Cap Value Index (VISVX: news, chart, profile).

It's easy to compare this very simple four-fund strategy with the total stock market fund. To do so, I looked back to the start of 1999 for a five-calendar-year period that includes a raging bull market, then three years of the worst bear market in most people's memory and finally a strong recovery last year.

The table below shows year-by year comparisons of the returns of the total stock market fund with the four-index-fund approach we recommend. These returns go back to 1999, the first full calendar year in which the Vanguard Small-Cap Value Index Fund was operational.

Comparing annual returns

Total Stock Market Fund...Four-fund mix
1999...-23.8%...15.1%
2000...-10.6%....4.1%
2001...-11%.....-1.3%
2002...-21%.....-7.2%
2003...-31.4%...35.9%

The Total Stock Market Fund outperformed this four-fund combination in only one of these years. A $20,000 investment in the Total Stock Market Fund at the start of 1999 would have grown to $20,450 by the end of 2003. The same investment in the four-fund combo, with annual rebalancing, would have grown to $29,829.

The combination I advocate is not fancy or expensive. It is built on four Vanguard index funds. Why John Bogle doesn't like it remains a mystery to me.