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Book Author: John Bogle
Book Title: The Little Book of Common Sense Investing
[Amazon Link]

Summary:

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Introduction:

- Simple arithmetic suggests, and simple arithmetic suggests, and history confirms, that the winning strategy is to own all of the nation’s publicly held businesses at very low cost.
- The best way to implement this The best way to implement this strategy is indeed simple: Buying a fund that holds this market portfolio, and holding it forever. Such a fund is called an index fund. The index fund is simply a basket (portfolio) that holds many, many eggs (stocks) designed to mimic the overall performance of any financial market or market sector.[1] Classic index funds, by definition, basically represent the entire stock market basket, not just a few scattered eggs. Such funds eliminate the risk of individual stocks, the risk of market sectors, and the risk of manager selection, with only stock market risk remaining (which is quite large enough, thank you). Index funds make up for their short-term lack of excitement by their truly exciting long-term productivity.
- today if you wish you could literally hold all your walls and a diversify the portfolio of a low-cost traditional index funds representing every asset class and every market sector within the United States or around the globe.
- This book will tell you why you should stop contributing to the croupiers of the financial markets, who rake in something like $400 billion each year from you and your fellow investors. It will also tell you how easy it is to do just that: simply buy the entire stock market. Then, once you have bought your stocks, get out of the casino and stay out. Just hold the market portfolio forever. And that’s what the index fund does.
- Charles T. Munger, Warren Buffett’s partner at Berkshire Hathaway, puts it this way: “The general systems of money management [today] require people to pretend to do something they can’t do and like something they don’t. [It’s] a funny business because on a net basis, the whole investment management business together gives no value added to all buyers combined. *That’s the way it has to work.* Mutual funds charge two percent per year and then brokers switch people between funds, costing another three to four percentage points. The poor guy in the general public is getting a terrible product from the professionals. I think it’s disgusting. It’s much better to be part of a system that delivers value to the people who buy the product.”

Chapter One: A Parable

- Investing returns decrease as motion increases.

- Accurate as that cryptic statement is, I would add that the parable reflects the profound conflict of interest between those who work in the investment business and those who invest in stocks and bonds. The way to wealth for those in the business is to persuade their clients, “Don’t just stand there. Do something.” But the way to wealth for their clients in the aggregate is to follow the opposite maxim: “Don’t do something. Just stand there.” For that is the only way to avoid playing the loser’s game of trying to beat the market.
- Here’s what he had to say in a 2004 *Business Week* interview: “The investment business is a giant scam. Most
- people think they can find managers who can outperform, but most people are wrong. I will say that 85 to 90 percent of managers fail to match their benchmarks. Because managers have fees and incur transaction costs, you know that in the aggregate they are deleting value.” When asked if private investors can draw any lessons from what Harvard does, Mr. Meyer responded, “Yes. First, get diversified. Come up with a portfolio that covers a lot of asset classes. Second, you want to keep your fees low. That means avoiding the most hyped but expensive funds, in favor of low-cost index funds. And finally, invest for the long term. [Investors] should simply have index funds to keep their fees low and their taxes down. *No doubt about it.”*

<u>Chapter Two - Rational Exuberance</u>

<u>Business Reality Trumps Market Expectations.</u>

- the price/earnings (P/E) ratio, which measures the number of dollars investors are willing to pay for each dollar of earnings. As investor confidence waxes and wanes, P/E multiples rise and fall.[6] When greed holds sway, we see very high P/Es. When hope prevails, P/Es are moderate. When fear is in the saddle, P/Es are very low.
- Rather, the reason that annual stock returns are so volatile is largely because of the emotions of investing, reflected in those changing P/E ratios.
- while illusion (the momentary prices we pay for stocks) often loses touch with reality (the intrinsic values of our corporations), in the long run it is reality that rules.
- To this crucial distinction, I would add that the expectations market is not only a product of the expectations of active investors but the expectations of active speculators, trying to guess what these investors will expect, and how they will act as each new bit of information finds its way into the marketplace. The expectations market is about speculation. The real market is about investing. The only logical conclusion: the stock market is a giant distraction that causes investors to focus on transitory and volatile investment expectations rather than on what is really important—the gradual accumulation of the returns earned by corporate business.
- The true investor . . . will do better *if he forgets about the stock market and pays attention to his dividend returns and to the operating results of his companies.”*
- the investor with a portfolio of sound stocks should expect their prices to fluctuate and should neither be concerned by sizable declines nor become excited by sizable advances. He should always remember that market quotations are there for his convenience, either to be taken advantage of or to be ignored.

Chapter Three: Cast Your Lot with Business Rely on Occam's Razor to Win by Keeping It Simple.

- In establishing a trust for his wife's estate, Warren Buffet directed that 90 percent of its assets be invested in a low-cost S&P 500 Index fund.

Chapter Four - How Most Investors Turn a Winner's Game into a Loser's Game "The Relentless Rules of Humble Arithmetic"

- In a market that returns 10 percent, we investors together earn a gross return of 10 percent. (Duh!) But after we pay our financial intermediaries, we pocket only what remains. (And we pay them whether our returns are positive or negative!)
- When our fund marketers cite the stock market's historical annual return of 9.5% since 1900 and ignore fund expenses of 2% and inflation of 3%, they suggest investors can expect a real, after-cost return of 9.5%. They shouldn't. The truth is that the real return to investors equal (you guessed it) only 4.5%.

Chapter Five - The Grand Illusion Surprise! The Returns Reported by Mutual Funds Aren't Actually Earned by Mutual Fund Investors.

- Investors should make expense ratios a primary test in fund selection. Start by focusing on funds in the cheapest or two cheapest quintiles, and you'll be on the path to success.

Chapter Seven- When the Good Times No Longer Roll What Happens If Future Returns Are Lower?

- As the market soared, investors poured ever larger sums of money into equity funds. They invested a net total of only $18 billion in 1990 when stocks were cheap, but $420 billion in 1999 and 2000, when stocks were overvalued
- The greatest Enemies of the Equity investor are Expenses and EMotions
- Most of Mr. Schwab's personal portfolio is invested in index funds.

Chapter Eight Selecting Long-Term Winner Don't Look for the Needle—Buy the Haystack.

- The index fund investor would be subject to taxes on any gains realized when liquidating shares. But for an investor who bequeaths shares to his heirs, the cost would be "stepped up" to their market value on date of death, and no capital gain would be recognized or taxed.
- Index funds are...tax friendly, allowing investors to defer the realization of capital gains or avoid them completely if the shares are bequeathed. Switching from security to security involved realizing capital gains that are subject to tax. Taxes are a crucially important financial consideration because the earlier realization of capital gains will substantially reduce net returns. Index funds do not trade from security to security and tend to avoid capital gain taxes.

Chapter Nine-Yesterday's Winners, Tomorrow's Losers
Fooled by Randomness

- My guess (it is little more than that) is that the P/E might ease down to, say, 16 times, reducing the market’s return by about 1 percentage point a year, to an annual rate of 7 percent. You don’t have to agree with me. If you think it will leap to 25 times, add 3 percentage points, bringing the total return on stocks to 11 percent. If you think it will drop to 12 times, subtract 4 percentage points; reducing the total return on stocks to 4 percent.
- Select a very low-cost index fund that simply holds the stock market portfolio
- Select funds with rock bottom costs, minimal portfolio turnover, and no sales loads.

Chapter Ten -Selecting Long-Term WInners

- Rather than selecting an actively managed mutual fund with a superior record, Buffet instructed trustees to invest 90% of the assets in the trust in a “very low-cost S&P 500 index fund.”

Chapter Twelve- “Seeking Advice to Select Funds?”

- My guess (it is little more than that) is that the P/E might ease down to, say, 16 times, reducing the market’s return by about 1 percentage point a year, to an annual rate of 7 percent. You don’t have to agree with me. If you think it will leap to 25 times, add 3 percentage points, bringing the total return on stocks to 11 percent. If you think it will drop to 12 times, subtract 4 percentage points; reducing the total return on stocks to 4 percent.
- ‘fee-only,’ that is, that he receives no remuneration from any other source besides you. . . . ‘Fee-only’ is not without pitfalls, however. Your adviser’s fees should be reasonable. It is simply not worth paying anybody more than 1 percent to manage your money. Above $1 million, you should be paying no more than 0.75 percent, and above $5 million, no more than 0.5 percent. . .. Your adviser should use index/passive stock funds wherever possible. If he tells you that he is able to find managers who can beat the indexes, he is fooling both you and himself. I refer to a commitment to passive indexing as ‘asset-class religion.’ Don’t hire anyone without it.”

Chapter Thirteen “Profit from the Majesty of Simplicity and Parsimony”

- Some are no-load funds, but nearly a third, as it turns out, have substantial front-end loads, often with an option to pay those loads over a period of (usually) five years; others entail the payment of a standard brokerage commission.
- The gap between the costs charged by the low-cost funds and the high-cost funds offered by 10 major fund organizations for their S&P 500-Index-based funds runs upward of an amazing 1.2 percentage points per year.
- Today, there are some 115 index mutual funds designed to track the S&P 500 Index. The wise investor will select only those index funds that are available without sales loads, and those operating with the lowest costs. These costs—no surprise here!—are directly related to the net returns delivered to the shareholders of these funds. (Page 160)

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- Even among the low-cost S&P 500 Index funds, we see a wide range of expenses. While the **Admiral class** of Vanguard's index fund carries a miniscule .04 percent expense ratio, the T. Rowe Price fund charges 0.25 percent.
- Today, there are some 40 traditional index mutual funds designed to track the S&P 500 Index, 14 of which carry front-end loads ranging between 1.5 percent and 5.75 percent. The wise investor will select only those index funds that are available without sales loads, and those operating with the lowest costs. These costs - no surprise here! - directly relate to the net returns delivered to the shareholders of these funds.
- International funds are also subject to the same allegation that is easier for managers to win in (supposedly) less efficient markets. But to no avail. S&P reports that its international index (world markets, less U.S. stocks) outpaced 89 percent of actively managed international equity funds over the past 15 years.
- Similarly, the S&P emerging markets index outpaced 90 percent of emerging market funds. With indexing so successful in both more efficient and less efficient markets alike, and in U.S. market and global markets, I'm not sure what additional data would be required to close the case in favor of index funds of all types.

Chapter Fourteen - Bond Funds

- Third, while bond yields are near their lowest levels since the early 1960s, the current yield on bonds (3.1 percent) still exceeds the dividend yield on stocks (2 percent).
- The SPIVA report also compares the returns of bond mutual funds in various categories to their appropriate benchmark indexes. During the 15-year period from 2001 to 2016, the performance of the bond indexes is also impressive outpacing an average of 85 percent of all actively managed bond funds in the six categories - short-term, intermediate-term, and long-term bond funds grouped by both U.S. government and investment grade corporate sectors. The appropriate indexes also outperformed the managers of municipal bond funds (84 percent) and high-yield bond funds (96 percent).
- In order to achieve such a 50/50 government/corporate bond portfolio, investors who require a higher yield than the total bond market index fund (yet still seek high-quality portfolio) might consider a portfolio consisting of 75 percent in the total bond market index fund and 25 percent in an investment-grade corporate bond index fund.

Chapter Fifteen - The Exchange-Traded Fund (ETF)

- But let me be clear. There is nothing wrong with investing in those indexed ETFs that track the broad stock market, just so long as you don't trade them. While short-term speculation is a loser's game, long-term investment is a proven strategy, one that broad market index funds are well positioned to implement.

Chapter Eighteen - Asset Allocation I: Stocks and Bonds

- We have suggested as a fundamental guiding rule that the investor should never have less than 25 percent or more than 75 percent of his funds in common stocks, with a consequent inverse range of between 75 percent and 25 percent in bonds. There is an implication here that the standard division should be an equal one, or a 50-50, between the two major investment mediums.

- When I discussed Graham's philosophy in my 1993 book *Bogle on Mutual Funds: New Perspectives for the Intelligent Investor,* the use of just two asset classes was my starting point. My recommendations for investors in the accumulation phase of their lives, working to build their wealth, focused on a stock/bond mix of 80/20 for younger investors and 70/30 for older investors. For investors starting the postretirement distribution phase, 60/40 for younger investors, 50/50 for older investors.
- In general, you are able to accept more risk if these liabilities are relatively far in the future. Similarly, as you accumulate more assets relative to your liabilities, your ability to take risk increases.
- Your willingness to take risk, on the other hand, is purely a matter of preference. Some investors can handle the ups and downs of the market without worry. But if you can't sleep at night because you're frightened about the volatility of your portfolio, you're probably taking more risk than you can handle. Taken together, your ability to accept risk and your willingness to accept risk constitute your *risk tolerance*.
- Let's begin with a basic allocation model for the accumulation of assets for the wealth-building investor. The main points to consider are merely common sense. (1) Investors seeking to accumulate assets by investing regularly can afford to take somewhat more risk - that is, to be more aggressive - than investors who have a relatively fixed pool of capital are dependent on income and even distributions from their capital to meet their day-to-day living expenses. (2) Younger investors, with more time to let the magic of compounding work for them, can also afford to be more aggressive, while older investors will likely want to steer a more conservative course.
- Graham's allocation guidelines are reasonable; mine are similar but more flexible. Your common stock position should be as large as your tolerance to risk permits. For example, my highest recommended general target allocation for stocks would be 80 percent for younger investors accumulating assets over a long time frame.
- Second, the decision to maintain either a fixed ratio or a ratio that varies with market returns cannot be sidestepped. The fixed ratio (periodically rebalancing to the original asset allocation) is a prudent choice that limits risk and may well be the better choice for most investors. The portfolio that is never rebalanced, however, is likely to provide higher long-term returns.
- Third is the decision as to whether to introduce an element of tactical allocation, varying the stock/bond ratio as market conditions change. Tactical allocation carries its own risks. Changes in the stock/bond ratio may add value, but (more likely, I think) they may not. In our uncertain world, tactical changes should be made sparingly, for they imply a certain prescience that few, if any of us, possess. In general, investors should not engage in tactical allocation.
- Fourth, and perhaps most important, is the decision as to whether to focus on actively managed mutual funds or traditional index funds. Clear and convincing evidence points to the index fund strategy.

- All four of these decisions require tough, demanding choices by the intelligent investor. With thoughtfulness, care, and prudence, you can make these choices sensibly.

Chapter Nineteen - Asset Allocation II

- Continually selling equities by such an investor to reduce the stock allocation might not make much sense, especially if you consider the potential for large taxes on capital gains that are realized when stocks with substantial appreciation are sold.

Chapter Twenty - Investment Advice That Meets the Test of Time

- Deep down, I remain absolutely confident that the vast majority of American families would be well served by owning their equity holdings in a Standard & Poor's 500 Index fund (or a total stock market index fund) and holding their bonds in a total bond market index fund. (Investors in high tax brackets, however, would instead own a very low-cost quasi-index portfolio of high-grade intermediate-term municipal bonds.)
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