THE LITTLE BOOK

of COMMON SENSE INVESTING

The Only Way to Guarantee Your Fair Share of Stock Market Returns

JOHN C. BOGLE

John Wiley & Sons, Inc.

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of COMMON SENSE INVESTING

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To Paul A. Samuelson, professor of economics at Massachusetts Institute of Technology, Nobel Laureate, investment sage.

In 1948 when I was a student at Princeton University, his classic textbook introduced me to economics. In 1974, his writings reignited my interest in market indexing as an investment strategy. In 1976, his *Newsweek* column applauded my creation of the world's first index mutual fund. In 1993, he wrote the foreword to my first book, and in 1999 he provided a powerful endorsement for my second. Now in his ninety-second year, he remains my mentor, my inspiration, my shining light.

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Introduction

Don't Allow a Winner's Game to Become a Loser's Game.

Successful investing is all about common sense. As the Oracle has said, it is simple, but it is not easy. 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. By doing so you are guaranteed to capture almost the entire return that they generate in the form of dividends and earnings growth.

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.* 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.

Index funds eliminate the risks of individual stocks, market sectors, and manager selection. Only stock market risk remains.

This is much more than a book about index funds. It is a book that is determined to change the very way that you think about investing. For when you understand how our financial markets actually work, you will see that the index fund is indeed the only investment that guarantees you will capture your fair share of the returns that business earns. Thanks to the miracle of compounding, the

* Keep in mind that an index may also be constructed around bonds and the bond market, or even "road less traveled" asset classes such as commodities or real estate. Today, if you wish, you could literally hold all your wealth in a diversified set of index funds representing asset classes within the United States or the global economy.

accumulations of wealth over the years generated by those returns have been little short of fantastic.

I'm speaking here about the classic index fund, one that is broadly diversified, holding all (or almost all) of its share of the $15 trillion capitalization of the U.S. stock market, operating with minimal expenses and without advisory fees, with tiny portfolio turnover, and with high tax efficiency. The index fund simply owns corporate America, buying an interest in each stock in the stock market in proportion to its market capitalization and then holding it forever.

Please don't underestimate the power of compounding the generous returns earned by our businesses. Over the past century, our corporations have earned a return on their capital of 9.5 percent per year. Compounded at that rate over a decade, each $1 initially invested grows to $2.48; over two decades, $6.14; over three decades, $15.22; over four decades, $37.72, and over five decades, $93.48.* The magic of compounding is little short of a miracle. Simply put, thanks to the growth, productivity, resourcefulness, and innovation of our corporations, capitalism creates

* These accumulations are measured in *nominal* dollars, with no adjustment for the long-term decline in their buying power, averaging about 3 percent a year since the twentieth century began. If we use real (inflation-adjusted) dollars, the return drops from 9.5 percent to 6.5 percent. As a result, the accumulations of an initial investment of $1 would be $1.88, $3.52, $6.61, $12.42, and $23.31 for the respective periods.

wealth, a *positive-sum game* for its owners. *Investing in equities is a winner's game.*

The returns earned by business are ultimately translated into the returns earned by the stock market. I have no way of knowing what share of these returns you have earned in the past. But academic studies suggest that if you are a typical investor in individual stocks, your returns have probably lagged the market by about 2.5 percentage points per year. Applying that figure to the annual return of 12 percent earned over the past 25 years by the Standard & Poor's 500 Stock Index, your annual return has been less than 10 percent. Result: your slice of the market pie, as it were, has been less than 80 percent. In addition, as explained in Chapter 5, if you are a typical investor in mutual funds, you've done even worse.

If you don't believe that is what most investors experience, please think for a moment, about the relentless rules of humble arithmetic. These iron rules define the game. As investors, all of us as a group earn the stock market's return. As a group—I hope you're sitting down for this astonishing revelation—we are average. Each extra return that one of us earns means that another of our fellow investors suffers a return shortfall of precisely the same dimension. *Before the deduction of the costs of investing, beating the stock market is a zero-sum game.*

But the costs of playing the investment game both reduce the gains of the winners and increases the losses of the losers. So who wins? You know who wins. The man in the middle (actually, the men and women in the middle, the brokers, the investment bankers, the money managers, the marketers, the lawyers, the accountants, the operations departments of our financial system) is the only sure winner in the game of investing. *Our financial croupiers always win.* In the casino, the house always wins. In horse racing, the track always wins. In the powerball lottery, the state always wins. Investing is no different. *After the deduction of the costs of investing, beating the stock market is a loser's game.*

Yes, after the costs of financial intermediation—all those brokerage commissions, portfolio transaction costs, and fund operating expenses; all those investment management fees; all those advertising dollars and all those marketing schemes; and all those legal costs and custodial fees that we pay, day after day and year after year—beating the market is inevitably a game for losers. No matter how many books are published and promoted purporting to show how easy it is to win, investors fall short. Indeed, when we add the costs of these self-help investment books into the equation, it becomes even more of a loser's game.

Don't allow a winner's game to become a loser's game.

The wonderful *magic of compounding returns* that is reflected in the long-term productivity of American business, then, is translated into equally wonderful returns in the stock market. But those returns are overwhelmed by the powerful *tyranny of compounding* the *costs* of investing. For those who choose to play the game, the odds in favor of the successful achievement of superior returns are terrible. Simply playing the game consigns the average investor to a woeful shortfall to the returns generated by the stock market over the long term.

Most investors in stocks think that they can avoid the pitfalls of investing by due diligence and knowledge, trading stocks with alacrity to stay one step ahead of the game. But while the investors who trade the least have a fighting chance of capturing the market's return, those who trade the most are doomed to failure. An academic study showed that the most active one-fifth of all stock traders turned their portfolios over at the rate of more than 21 percent per month. While they earned the market return of 17.9 percent per year during the period 1990 to 1996, they incurred trading costs of about 6.5 percent, leaving them with an annual return of but 11.4

percent, only two-thirds of the return in that strong market upsurge.

Fund investors are confident that they can easily select superior fund managers. They are wrong.

Mutual fund investors, too, have inflated ideas of their own omniscience. They pick funds based on the recent performance superiority of fund managers, or even their long-term superiority, and hire advisers to help them do the same thing. But, the advisers do it with even less success (see Chapters 8, 9, and 10). Oblivious of the toll taken by costs, fund investors willingly pay heavy sales loads and incur excessive fund fees and expenses, and are unknowingly subjected to the substantial but hidden transaction costs incurred by funds as a result of their hyperactive portfolio turnover. Fund investors are confident that they can easily select superior fund managers. They are wrong.

Contrarily, for those who invest and then drop out of the game and never pay a single unnecessary cost, the odds in favor of success are awesome. Why? Simply because they own *businesses,* and businesses as a group earn substantial returns on their capital and pay out dividends to their owners. Yes, many individual companies fail. Firms with flawed ideas and rigid strategies and weak managements ultimately

fall victim to the *creative destruction* that is the hallmark of competitive capitalism, only to be succeeded by others.* But in the aggregate, businesses grow with the long-term growth of our vibrant economy.

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.

This investment philosophy is not only simple and elegant. The arithmetic on which it is based is irrefutable. But it is not easy to follow its discipline. So long as we investors accept the status quo of today's crazy-quilt financial market system; so long as we enjoy the excitement (however costly) of buying and selling stocks; so long as we fail to realize that there is a better way, such a philosophy will seem counterintuitive. But I ask you to carefully consider the impassioned message of this little book. When you do, you, too, will want to join the revolution and invest in a new, more economical, more efficient, even more honest way, a more productive way that will put your own interest first.

* "Creative destruction" is the formulation of Joseph E. Schumpeter in *Capitalism, Socialism, and Democracy,* 1942.

It may seem farfetched for me to hope that any single little book could ignite the spark of a revolution in investing. New ideas that fly in the face of the conventional wisdom of the day are always greeted with doubt, scorn, and even fear. Indeed, 230 years ago the same challenge was faced by Thomas Paine, whose 1776 tract *Common Sense* helped spark the American Revolution. Here is what Tom Paine wrote:

> Perhaps the sentiments contained in the following pages are not yet sufficiently fashionable to procure them general favor; a long habit of not thinking a thing wrong, gives it a superficial appearance of being right, and raises at first a formidable outcry in defense of custom. But the tumult soon subsides. Time makes more converts than reason.
>
> In the following pages, I offer nothing more than simple facts, plain arguments, and common sense; and have no other preliminaries to settle with the reader, than that he will divest himself of prejudice and prepossession, and suffer his reason and his feelings to determine for themselves; that he will put on, or rather that he will not put off, the true character of a man, and generously enlarge his views beyond the present day.

As we now know, Thomas Paine's powerful and articulate arguments carried the day. The American Revolution led to our Constitution, which to this day defines the responsibility of our government, our citizens, and the fabric of our society. Inspired by his words, I titled my

1999 book *Common Sense on Mutual Funds,* and asked investors to divest themselves of prejudice and to generously enlarge their views beyond the present day. In this new book, I reiterate that proposition.

If I "could only explain things to enough people, carefully enough, thoroughly enough, thoughtfully enough—why, eventually everyone would see, and then everything would be fixed."

In *Common Sense on Mutual Funds,* I also applied to my idealistic self these words of the late journalist Michael Kelly: "The driving dream (of the idealist) is that if he could only explain things to enough people, carefully enough, thoroughly enough, thoughtfully enough—why, eventually everyone would see, and then everything would be fixed." This book is my attempt to explain the financial system to as many of you who will listen carefully enough, thoroughly enough, and thoughtfully enough so that you will see, and it will be fixed. Or at least that your own participation in it will be fixed.

Some may suggest that, as the creator both of Vanguard in 1974 and of the world's first index mutual fund in 1975, I have a vested interest in persuading you of my views. Of course I do! But not because it enriches me to do so. It doesn't earn me a penny. Rather, I want to per-

suade you because the very elements that formed Vanguard's foundation all those years ago—all those values and structures and strategies—will enrich *you*.

In the early years of indexing, my voice was a lonely one. But there were a few other thoughtful and respected believers whose ideas inspired me to carry on my mission. Today, many of the wisest and most successful investors endorse the index fund concept, and among academics, the acceptance is close to universal. *But don't take my word for it*. Listen to these independent experts with no axe to grind except for the truth about investing. You'll hear from some of them at the end of each chapter.

Listen, for example, to this endorsement by Paul A. Samuelson, Nobel Laureate and professor of economics at Massachusetts Institute of Technology, to whom this book is dedicated: "Bogle's reasoned precepts can enable a few million of us savers to become in twenty years the envy of our suburban neighbors—while at the same time we have slept well in these eventful times."

Put another way, in the words of the Shaker hymn, "Tis the gift to be simple, tis the gift to be free, tis the gift to come down where we ought to be." Adapting this message to investing by simply owning an index fund, you will be free of almost all of the excessive costs of our financial system, and will receive, when it comes time to

draw on the savings you have accumulated, the gift of coming down just where you ought to be.

The financial system, alas, won't be fixed for a long time. But the glacial nature of that change doesn't prevent you from looking after your self-interest. You don't need to participate in its expensive foolishness. If you choose to play the winner's game of owning businesses and refrain from playing the loser's game of trying to beat the market, you can begin the task simply by using your own common sense, understanding the system, and investing in accordance with the only principles that will eliminate substantially all of its excessive costs. Then, at last, whatever returns our businesses may be generous enough to deliver in the years ahead, reflected as they will be in our stock and bond markets, you will be guaranteed to earn your fair share. When you understand these realities, you'll see that it's all about common sense.

John C. Bogle

Valley Forge, Pennsylvania
January 5, 2007

Don't Take My Word for It

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."

William Bernstein, investment adviser (and neurologist), and author of *The Four Pillars of Investing,* says: "It's bad enough that you have to take market risk. Only a fool takes on the additional risk of doing yet more damage by failing to diversify properly with his or her nest egg. Avoid the problem—buy a well-run index fund and own the whole market."

Here's how the *Economist* of London puts it: "The truth is that, for the most part, fund managers have offered extremely poor value for money. Their

(continued)