Notes from the Bogleheads-8 (BH-8) Reunion

Fort Worth, TX
30 Sep - 2 Oct 2009

By: Bill Bernstein, Victoria Fineberg, Taylor Larimore, Mel Lindauer, Paul Stratton, and Ed Tower

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1 Introduction

The 8th Bogleheads reunion (BH-8) was announced[1] on 21 Jan 09. It was sponsored by the Dallas BH chapter and took place at Ft. Worth, TX, on 30 Sep - 2 Oct 09.

In addition to this report, BH-8 is discussed in the Bogleheads Forum[2], in discussions:

- Bogleheads 8 September 30 - October 2, 2009[3]

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[1] http://www.bogleheads.org/forum/viewtopic.php?t=31473
[2] http://www.bogleheads.org/forum/index.php

- real-time blogging of BH8 from allan roth[4]
- Bogleheads 8 Photos[5]
- BOGLEHEADS 8 DVD SET AVAILABLE[6]
- Favorite Bit of Knowledge from Bogleheads 8[7]
- and some others.

2 *Day-1 - 30 Sep 09 - Mr. Bogle's letter to BH-8*

Greetings Bogleheads,

I'm crestfallen that I can't be with you this year.

I trust you all know me well enough by now to know that I'd move heaven and earth to be with you if I could, but alas, while the spirit is always willing, my aging body is not always able.

I've been quite ill over the past few weeks, battling a very serious blood infection. The good news is that thanks to the wonderful care I've received from countless doctors and nurses, I have been making a good deal of progress. It will likely be a few weeks yet before I'm well enough to resume anything close to my normal schedule, but day by day, inch by inch, I'm getting better; something that, at 80 years of age, I count as a true blessing.

Among the numerous other blessings I've received in my long life are you, the Bogleheads. I say that not because of the tremendous boost you provide my considerable ego (although you indeed do that). Rather, as I wrote in the foreword to the marvelous new Boglehead book, getting to know all of you over the past ten years has been one of the most rewarding experiences of my long career, in part because you represent the fulfillment of what I have dedicated my career to building.

You've doubtless heard me describe the enormous skepticism I faced when I founded Vanguard 35 years ago. The "Vanguard Experiment" was built on the faith that individual investors, seeking nothing more than to maximize their own self-interest, would be able to see through the fog of misinformation produced by Wall Street, and choose to entrust their savings to a firm that promised nothing more than to put their clients' interests first, and provide them with their fair share of whatever returns the markets provided.

And so I thank you. Thank you for proving the skeptics wrong and confirming that my faith was well-placed. Thank you for the countless hours you log and the boundless energy you display in helping your fellow investors, day in and day out, on the

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[3] http://www.bogleheads.org/forum/viewtopic.php?t=43875
[4] http://www.bogleheads.org/forum/viewtopic.php?t=43715
[5] http://www.bogleheads.org/forum/viewtopic.php?t=43914
[6] http://www.bogleheads.org/forum/viewtopic.php?t=44281
[7] http://www.bogleheads.org/forum/viewtopic.php?t=43859

Bogleheads message board. Thank you for your tireless efforts in combating Wall Street's cost and complexity with your own gospel of low costs and simplicity. But most of all, thank you for honoring, in your daily work, and in the trust you place in Vanguard, this aging mutual fund veteran. I count your high esteem as one of my career's signal accomplishments. It means more to me than you could ever know.

So enjoy your reunion, and know that you'll be in my thoughts. God bless you all, and see you, God willing, at Bogleheads 9 in 2010.

Best,
Jack Bogle

3 Day-2 - 01 Oct 09

3.1 Bogleheads introductions 09:00-11:00

Mel Lindauer introduced the panel:

- Bill Bernstein ("**Bill**")
- Laura Dogu ("**Laura**")
- Rick Ferri ("**Rick**")
- Taylor Larimore ("**Taylor**")
- Mel Lindauer ("**Mel**")
- Sue Stevens ("**Sue**")
- Ed Tower ("**Ed**").

Mel also introduced some notable participants in the audience. Bill Faloon is the Wiley[8] publisher of new books "The Bogleheads' Guide to Retirement Planning" by Taylor Larimore, Mel Lindauer, Richard A. Ferri and Laura F. Dogu[9], and "The Investor's Manifesto: Preparing for Prosperity, Armageddon, and Everything in Between" by William J. Bernstein[10]. Wiley also published "Common Sense on Mutual Funds" by John C. Bogle[11], "The ETF Book: All You Need to Know About Exchange-Traded Funds" by Richard A. Ferri[12], the original "The Bogleheads' Guide to Investing" by Taylor Larimore, Mel Lindauer and Michael LeBoeuf[13], as well as other books by Boglehead authors.

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8 http://www.wiley.com/WileyCDA/
9 Available at Amazon.com: http://www.amazon.com/Bogleheads-Guide-Retirement-Planning/dp/B002QX44IS/ref=sr_1_2?ie=UTF8&s=books&qid=1256482440&sr=8-2
10 Amazon.com release on 2 Nov 09: http://www.amazon.com/Investors-Manifesto-Prosperity-Armageddon-Everything/dp/0470505141/ref=sr_1_2?ie=UTF8&s=books&qid=1256482991&sr=8-2
11 Amazon.com release of the 10th Ed on 2 Dec 09 : http://www.amazon.com/Common-Sense-Mutual-Funds-Bogle/dp/0470138130/ref=sr_1_1?ie=UTF8&s=books&qid=1256601648&sr=8-1
12 Available at Amazon.com: http://www.amazon.com/ETF-Book-About-Exchange-Traded-Funds/dp/0470537469/ref=sr_1_1?ie=UTF8&s=books&qid=1256601850&sr=1-1
13 Available at Amazon.com: http://www.amazon.com/Bogleheads-Guide-Investing-Taylor-Larimore/dp/0470067365/ref=sr_1_1?ie=UTF8&s=books&qid=1256602079&sr=1-1

Mel then introduced Alan Roth, the author of "How a Second Grader Beats Wall Street: Golden Rules Any Investor Can Learn[14]", and Steve Dunn, the originator of "Dunn's Law."

After that, Mel then introduced the coordinators of BH-8 and local chapter coordinators. He noted that we now have a European chapter based in Paris, France.

Mel asked people who were attending a Bogleheads reunion for the first time to rise. He then asked for people who were here for the second, third, etc., time to rise.

Mel introduced the primary authors/editors of "The Bogleheads' Guide to Retirement Planning" and authors of individual chapters. Rick described how the idea of the book came about. Laura shared how the team collaborated using Google, following Dan Kohn's suggestion, without any face-to-face meetings or even speaking to each other. Mel added that Appendix I, "Pearls of Wisdom," includes insights from many Bogleheads who shared them in the Bogleheads Forum[15].

Personal introductions followed, table-by-table. They are captured in the BH-8 video[16] and provide a unique opportunity to hear personal stories behind many Bogleheads' participants, in their own words. Among participants, we had Erik Olsen, 2006-08 National President of AARP[17] [formerly known as the American Association of Retired Persons], who described his meeting with Warren Buffet. Steve Dunn provided insights into how he and Bill Bernstein launched "Dunn's Law." Many others shared amazing stories of financial successes -- but most frequently, mistakes and blunders -- that brought them to the Bogleheads.

3.2 Call to Mr. Bogle 11:15

At 11:15, as requested by Mr. Bogle, Mel made a call to the hospital where Mr. Bogle was at the time and put him on the speakerphone. Mr. Bogle welcomed Bogleheads to the BH-8 reunion and expressed his regrets that he could not be there with us in person. Mr. Bogle said that he is planning to take better care of himself and cut back on his 50-hour work weeks.

This year is a 10-year anniversary of Mr. Bogle's book "Common Sense on Mutual Funds", and the 10th edition with David Swensen's foreword will be available soon[18]. Everything that Mr. Bogle wrote in the book ten years ago came true. Mr. Bogle was right in his investment ideas; however, he was wrong in his optimism that the investment industry would reform to better serve their customers. Mr. Bogle then took a question.

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[14] Available at Amazon.com: http://www.amazon.com/Second-Grader-Beats-Wall-Street/dp/0470375949/ref=sr_1_1?ie=UTF8&s=books&qid=1256483073&sr=1-1

[15] http://www.bogleheads.org/forum/viewtopic.php?t=31636

[16] Discussion of the videos is at http://www.bogleheads.org/forum/viewtopic.php?t=44281 ; order videos from bogleheads@gmail.com

[17] http://www.aarp.org/

[18] Amazon.com release of the Deluxe 10th Edition on 2 Dec 09 at http://www.amazon.com/Common-Sense-Mutual-Funds-Bogle/dp/0470138130/ref=sr_1_1?ie=UTF8&s=books&qid=1256490175&sr=1-1

Q. Your thoughts about the economy and its outlook?

Jack: We have a deeply troubling economy, which is about $18T in terms of the GDP [Gross Domestic Product], and the *stock market drop* was about a half of that. But the *economy* cannot drop so much so quickly. We should be focused on the economy and not on the market. We spend too much time examining earnings and fail to notice tremendous write-offs.

In 2000, we were paying close to $6 [based on the market cap] for every $1 of the book value; and now, we are paying about $1.8. This is a huge drop in the market-to-book value. We are now at a reasonable market level, but it is not necessarily "cheap." The economy will be growing more slowly than in the recent past, but we are likely to see about 3% real growth. Still, I am uneasy about the state of the market.

I have to go now. God bless you all.

[Standing ovation.]

3.3 Kevin Laughlin's presentation

Kevin Laughlin, Mr. Bogle's "right arm," then provided commentary and later sent the accompanying charts, Figures 1 through 5 below.

This is a year of the 10th anniversary of the "Common Sense on Mutual Funds," and it is remarkable how quickly the climate has changed. When the book was published in 1999, Jack was very conservative and was cautiously referring to 12% growth -- at the time when the market returns were ~17% annually, and people were expecting higher returns. The core message that was relevant then is still relevant now:

- Keep things simple.
- Go for low cost.
- Diversify widely.
- Maintain proper asset allocation.

This advice served people well.

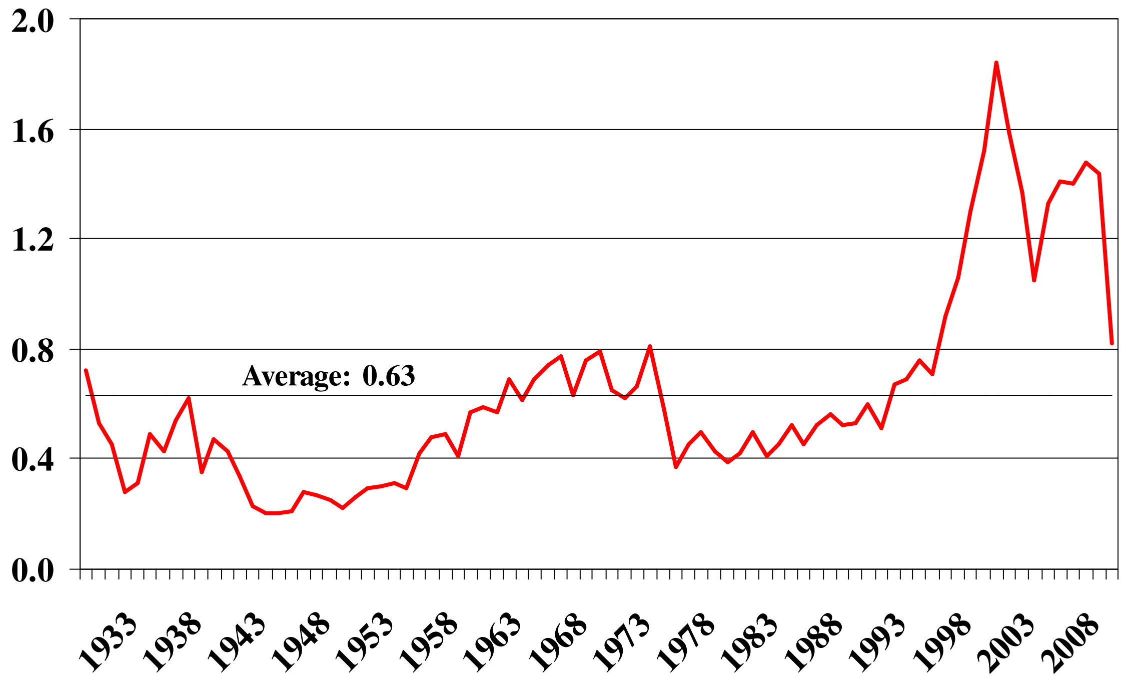

Figure 1. Market Cap / GDP, 1929 – 2008.

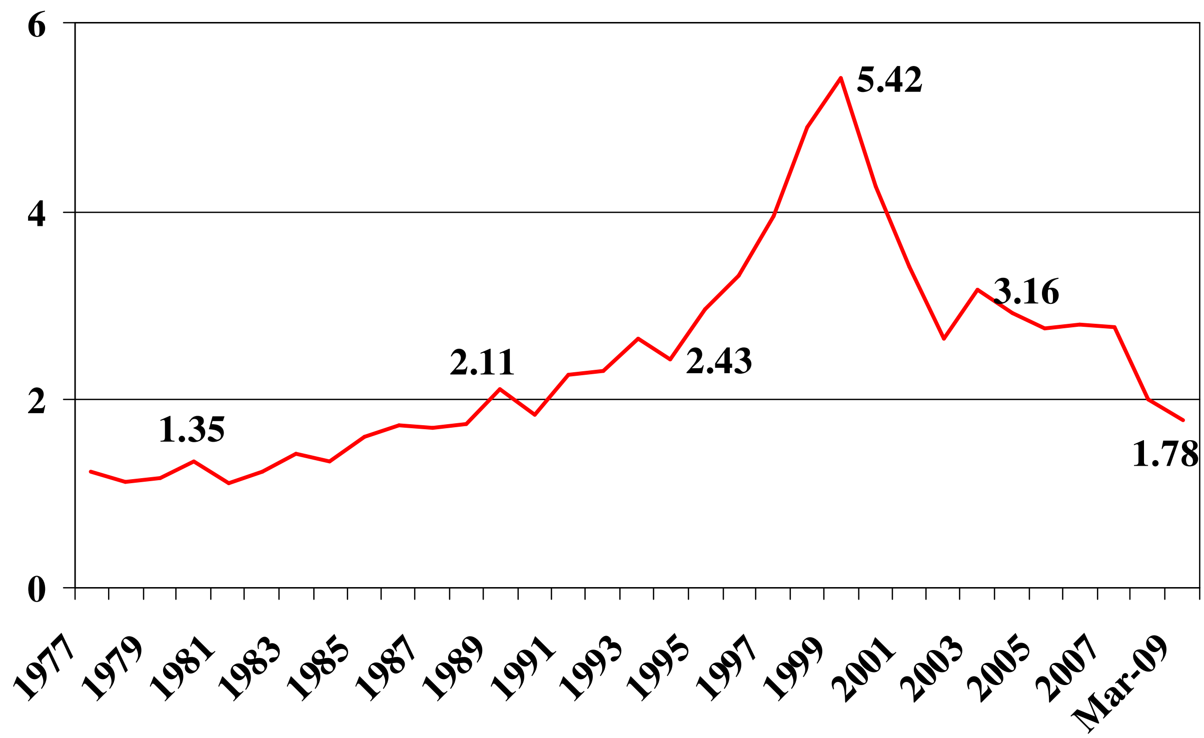

Figure 2. S&P 500 Price/Book Ratio, 1977 – 2009.

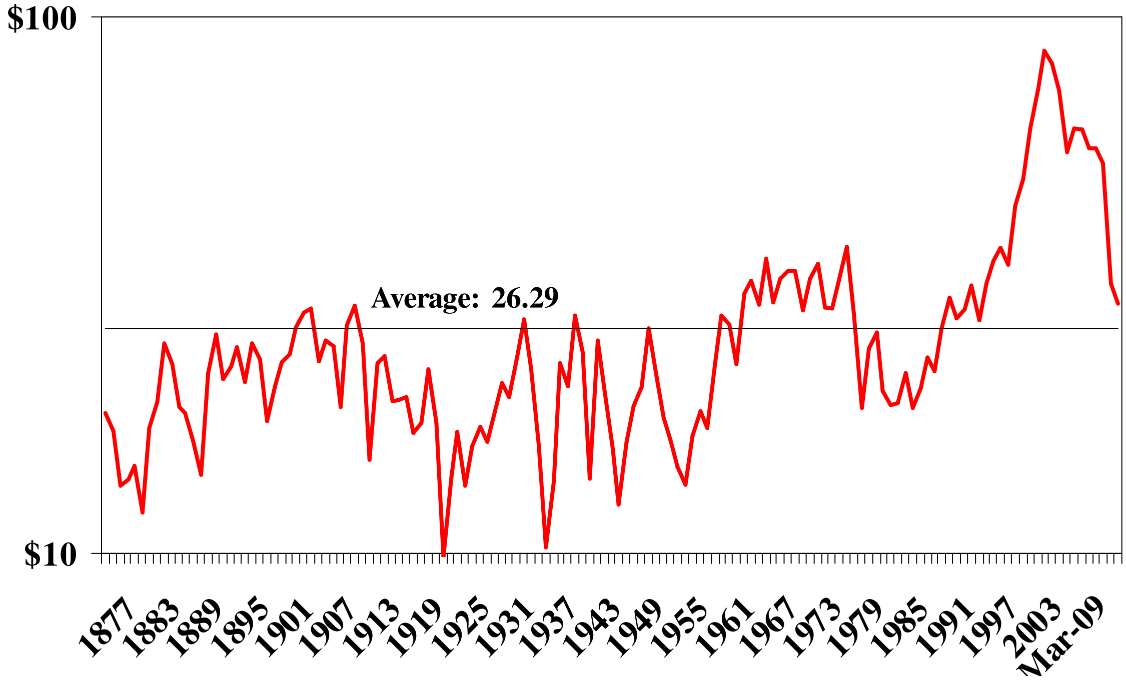

Figure 3. Price for $1 of Dividends, 1871 – 2009.

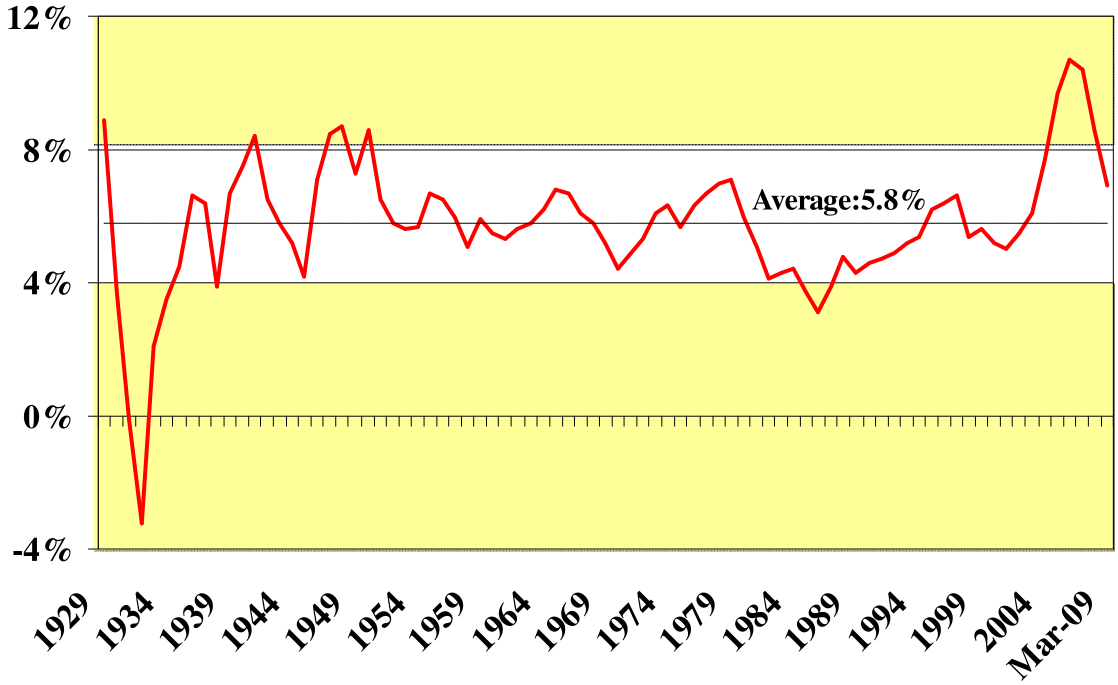

Figure 4. After-Tax Corporate Profits as Share of GDP, 1929 – 2009.

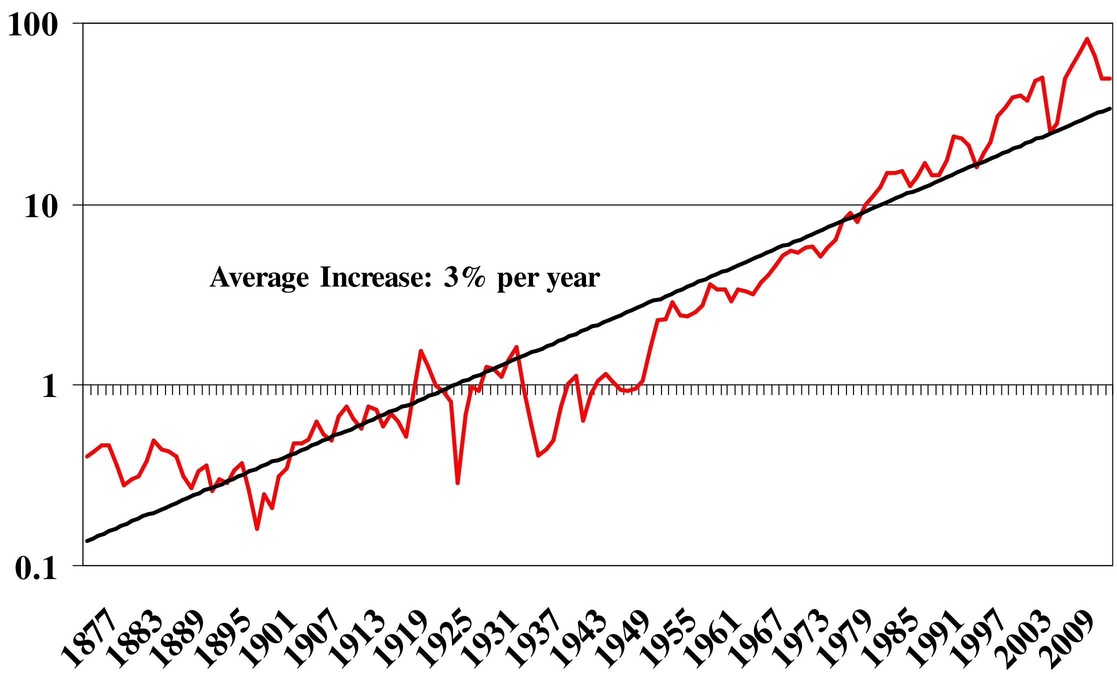

Figure 5. S&P 500 Earnings, 1872 – 2009.

Jack is extremely disappointed that he could not affect the change in the mutual fund industry. Jack has a lot of criticism of ETFs [Exchange Traded Funds], but some people misunderstood it. When Jack gave a presentation on how horrible *some of* these ETFs are it was not well received, because of the influence of ETF managers and their PR [Public Relations] departments.

The proponents of the ETFs were saying that they were trying to meet the need and help the public diversify. Jack was responding that they did not understand that investment managers have a fiduciary responsibility to provide clients with the most appropriate investments for them. This created a disconnect between Jack and the rest of the industry. While he was defending investors, everybody else was in the race to the bottom -- no matter what it meant to their clients. Still, Jack is optimistic that investors will help driving the industry where it is supposed to be.

Jack has filed a brief with the U.S. Supreme Court,[19] docket # 08-586, for the case "Jones vs. Harris Associates", where the issue is charges and fees imposed by mutual fund companies on investors. The arguments will be heard on 2 Nov 09 with Mr. Bogle's brief in support of the petitioners available on line[20]. This is a fascinating read.

<u>Q.</u> What is like to work for a 80-year old tornado?

[19] http://origin.www.supremecourtus.gov/docket/08-586.htm
[20] [PDF] http://www.abanet.org/publiced/preview/briefs/pdfs/07-08/08-586_PetitionerAmCuJBogle.pdf

Kevin: I just passed my 10th anniversary working for Jack. When I started I was a single guy; now I have wife and two children. I worked with Jack through the Internet bubble burst and traveled with him to Washington, D.C., to testify to various committees. I was sitting behind the guy who was testifying☺. It has been an amazing experience. If Jack was not such a genuinely good guy, I would not have stuck around for ten years working for him.

Jack is a remarkable individual. Take Jack's statement about cutting down on work with a grain of salt. This is not the first time he is saying this-- to his wife's chagrin. He sees something in a newspaper and takes off for another six months.

I love what I do, but I am not sure I [Kevin] would like to do that when I am 80-years old. In the past couple weeks I gained new appreciation of how powerful Jack's will is.

Mel: Jack has alluded to part-time work. Can you envision Jack retiring? Is there a succession in the Bogle Financial Markets Research Center[21]?

Kevin: I cannot envision Jack willingly retiring. We also hope that people in this room will continue his work and spread his message.

Mel: Kevin, please keep us informed about Jack's condition. All, BH-9 will be held in Philadelphia, and Kevin will be our coordinator.

3.4 Continuation of introductions

After the call to Mr. Bogle and Kevin Laughlin's presentation, the Bogleheads resumed going around the room with introductions. Mel recalled how the 1st Bogleheads reunion took place on Jack's initiative. Taylor, his wife Pat, and Mel hosted that gathering in his 35th floor condo overlooking Biscayne Bay, Florida. 24 people from the U.S. and Canada attended the meeting, and that was how the tradition was born.

At the end of the introduction, Mel announced that Sunny and Rich will be filming individual Bogleheads "Get Well Wishes" to Jack in the lobby.

After administrative announcements, the meeting adjourned until 18:00.

3.5 Bill Bernstein's presentation 18:30

Mel provided the background. A couple years ago, Jack asked for a fireside chat at a Bogleheads' meeting with Bill Bernstein. And what Jack wants he gets here☺ , and the chat between Jack and Bill became a tradition. Here is Bill.

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[21] http://www.vanguard.com/bogle_site/bogle_home.html

Bill. When I come to these meetings, I meet all these people who read all books written by me, Rick Ferri, and Larry Swedroe. By all means, you do not need to read us all; you can stop at one. We are all saying the same thing, and after one book the learning curve is rather shallow.

In 2008 we learned how expansive the markets are in both directions. I used to think that one or two bubbles may blow but other assets would hold. I did not think it was possible to blow bubbles in all of these areas at once.

I started reading about the origins of credit markets. 400 years ago, England was in a bad shape. Early 17th century ships were returning with gold and jewelry, but there was no place to put it. People would give things to jewelers who would in return give people certificates, but these certificates were not liquid. And so jewelers started printing certificates and lending them on interest. At any sign of a problem there was an equivalent of a bank run.

Banks quietly took it over. For example, after a depositor gave $1 to a bank, credit could be expanded by a factor of 9, e.g., if the bank lent 90 cents to another bank and kept 10 cents. The borrowing bank would lend 90 cents to another bank in the same way, etc.; thus expanding credit. If the original investor wanted his $1 back, the original chain would reverse. And so banking was expanding and contracting.

Charles Kindleberger's "Manias, Panics, and Crashes: A History of Financial Crises[22]" may not be the most exciting read … unless you have a crisis. It describes how 46 different crises came about.

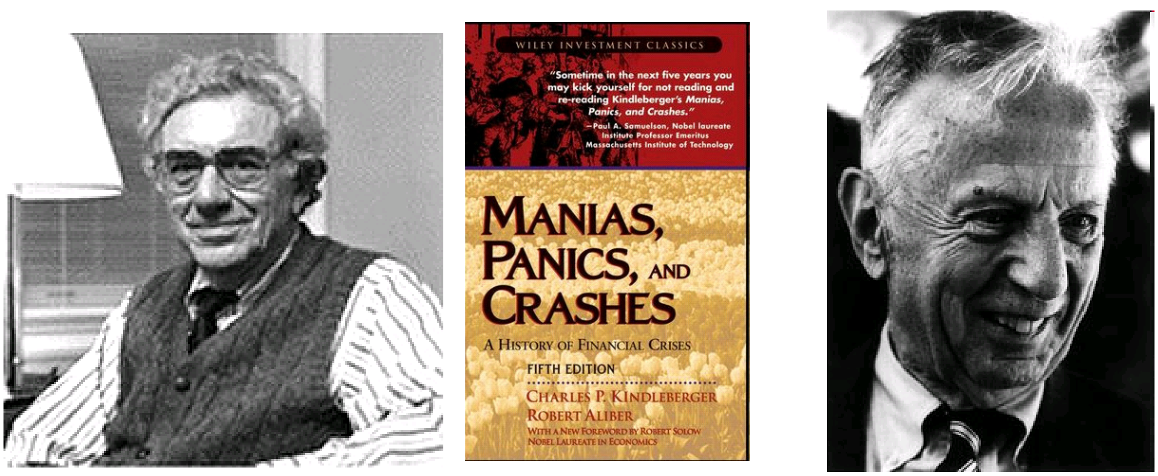

Figure 6. Manias, Panics, and Crashes

Another guy to read is Hyman Minsky[23] who proposed the financial instability hypothesis. To increase returns you have to jack up leverage. Then the system crashes,

[22] Available at Amazon.com: http://www.amazon.com/Manias-Panics-Crashes-Financial-Investment/dp/0471389455

people become cautious, and the system stabilizes. People start taking risks again, and thus the (capitalist) system oscillates between stability and instability.

On the next slide I show corporate short-term bond yields (top graph), Treasury yields, and the spread on the bottom.

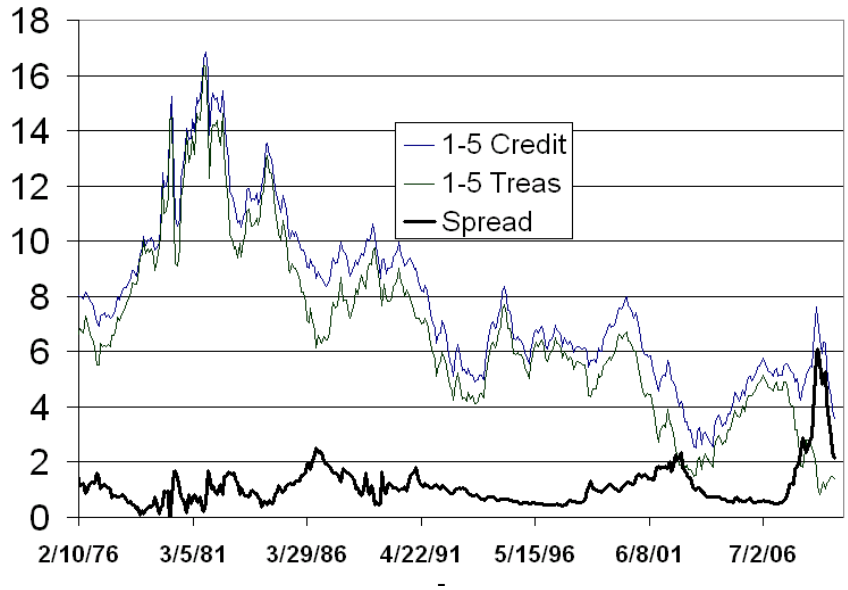

Figure 7. Short-term bond yields and spreads, 1976 - 2006.

Why people do it? The answer is in the structure of the brain.

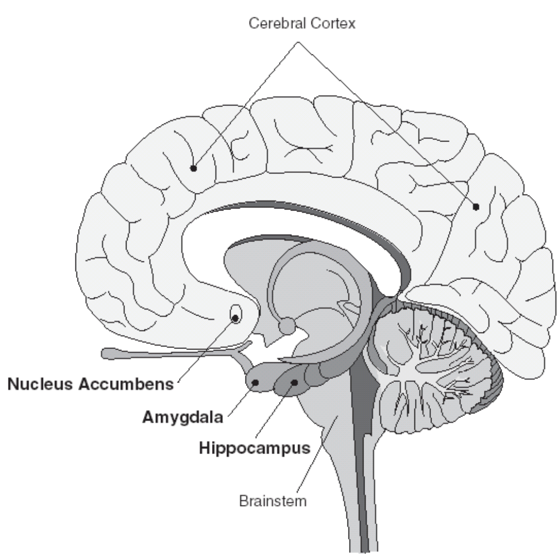

Figure 8. Structure of the human brain.

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23 Wikipedia http://en.wikipedia.org/wiki/Hyman_Minsky

The limbic system of a frog does not look much different from that of an investment banker. When Jason Zweig gives lectures he sometimes throws a rubber snake into the first row. First, people recoil -- that's their limbic system performing its function. Then the outer cortex takes over, but it is much slower. Anticipation is better than pleasure.

Here are some representative quotes:

"There is nothing so disturbing to one's well-being and judgment as to see a friend get rich." Charles P.Kindleberger, 2000.

"As long as the music is playing, you've got to get up and dance. We're still dancing." Charles Prince, Chairman, Citigroup.

And so let's see how bond spreads behaved in recent times.

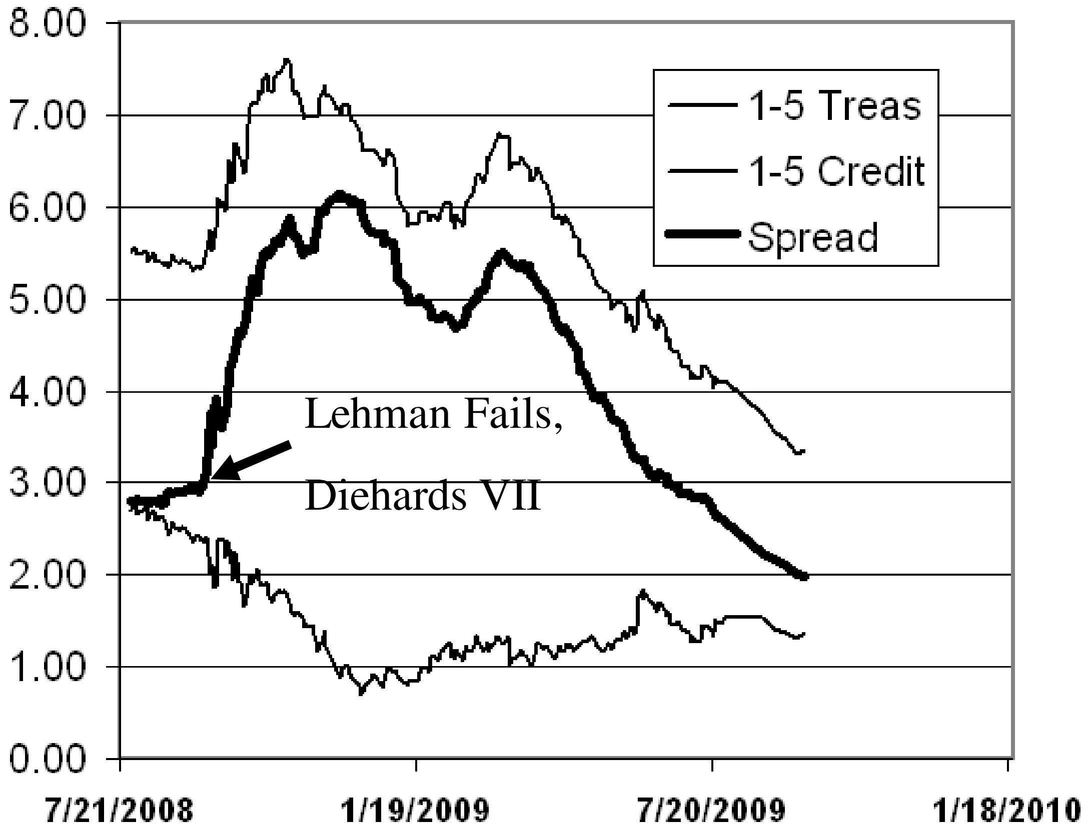


Figure 9. Short-term bond yields and spreads, 2008 - 2009.

In Figure 9, corporate bonds are the top curve, and you can see how they spiked to almost 8% after the failure of Lehman Brothers; the Treasuries are on the bottom; and the spread (the heavy line) is high until recently. The next slide shows what happened to investors.

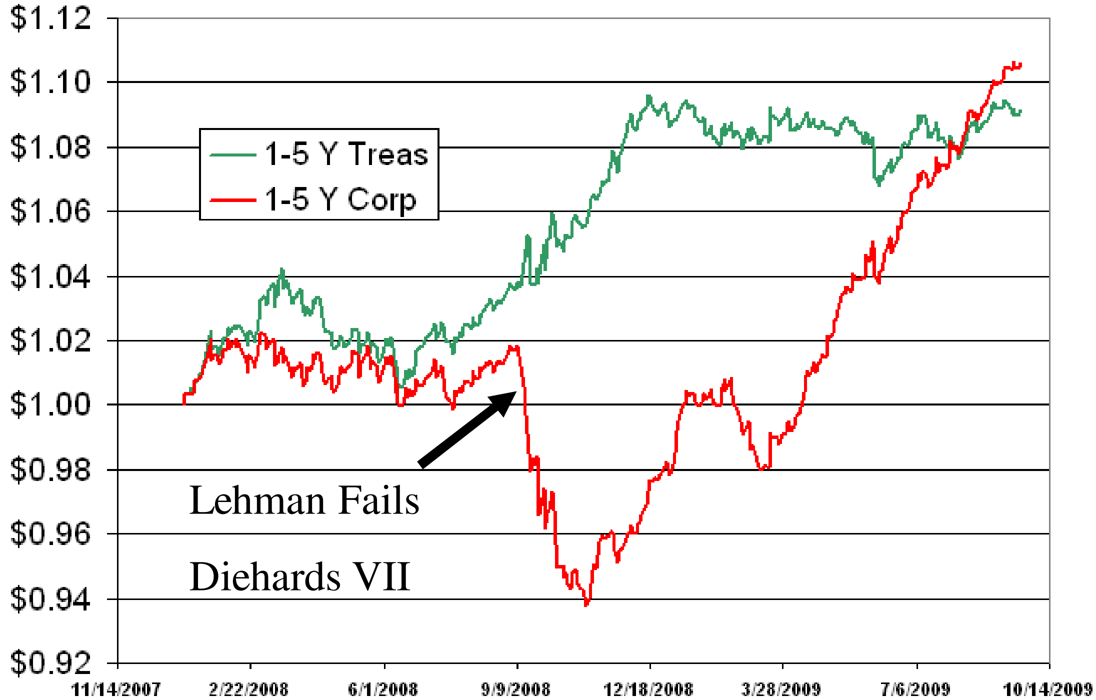


Figure 10. Investor performance in 2008 – 2009.

When Lehman failed (and yields rose), corporate bonds dropped. The next slide shows how active fund managers fared.

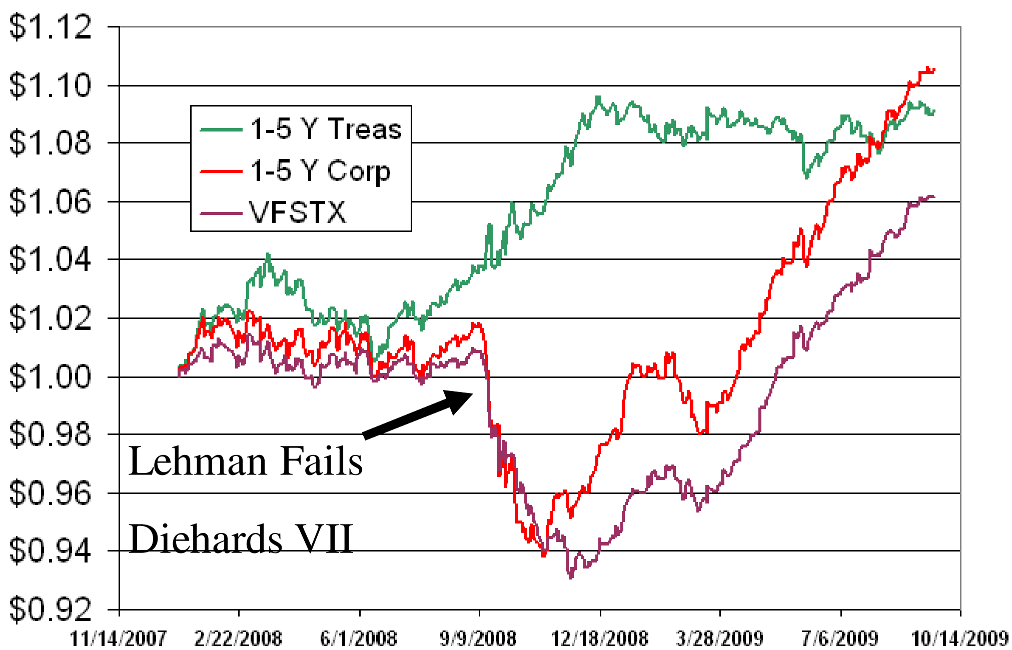


Figure 11. Active bond managers in 2008 – 2009.

And so I learned a few things from the recent crisis:

1. I was surprised how sharply bonds dropped in September 2008, but I also learned from it.
2. I now understand why Warren Buffet likes Treasuries.
    a. They can pay your living expenses.
    b. With Treasuries you can rebalance when all other things are "on sale."
3. Active bond managers perform no better than individual investors. For example, because the VFSTX fund manager bought asset-backed securities, he incurred capital losses.

Vanguard has not seriously addressed this issue, but they will be bringing out an indexed corporate bond fund. However, this bond fund will not be available to individual investors.

Remember that the risk budget includes components as follows:
- Market Exposure
- Small Exposure
- Value Exposure
- Duration
- Credit Quality.

4 Day-3 - 02 Oct 09

4.1 Ed Tower's presentation and paper

Ed presented some slides from the study "Vanguard versus DFA & WisdomTree, and the Value Added by Dan Wiener" by Ed Tower and Yichong Zhang[24]. After the meeting, Ed kindly provided the slides together with the paper that explains the study for the BH-8 participants. This section presents the paper in its entirety.

"Vanguard versus DFA & WisdomTree, and the Value Added by Dan Wiener"

Prepared for the Bogleheads 8 Meeting in Dallas, Texas, Sep 30-Oct 2, 09
by Ed Tower and Yichong Zhang

[24] The authors are Professor and master's candidate at Duke University respectively. Tower is also a visiting professor of economics at Chulalongkorn University. Their emails are tower@econ.duke.edu and jacobtcttc@hotmail.com. They welcome comments on this paper. Thanks go to Bill Bernstein, Mel Lindauer, Kathleen Ryan, and Paul Stratton for helpful comments. Ed Tower's office hone: 919-660-1818. This draft is dated October 27, 2009.

4.1.1 Introduction

This paper is an enhanced version of a short presentation that Ed Tower gave at the Bogleheads 8 meeting in Dallas, Texas, October 2, 2009. This version explores some issues in greater depth and corrects some computational errors.

We asked whether the enhanced indexing approaches of Dimensional Fund Advisors (DFA) and WisdomTree have outperformed Vanguard investors. This answer supplements Tower (2009b).

The recent wild gyrations of the stock market make looking at this issue now particularly interesting. The earlier chapter examined style-adjusted performance. Here we look at how investors with the Vanguard performed, compared with investors in the DFA and WisdomTree alternatives.

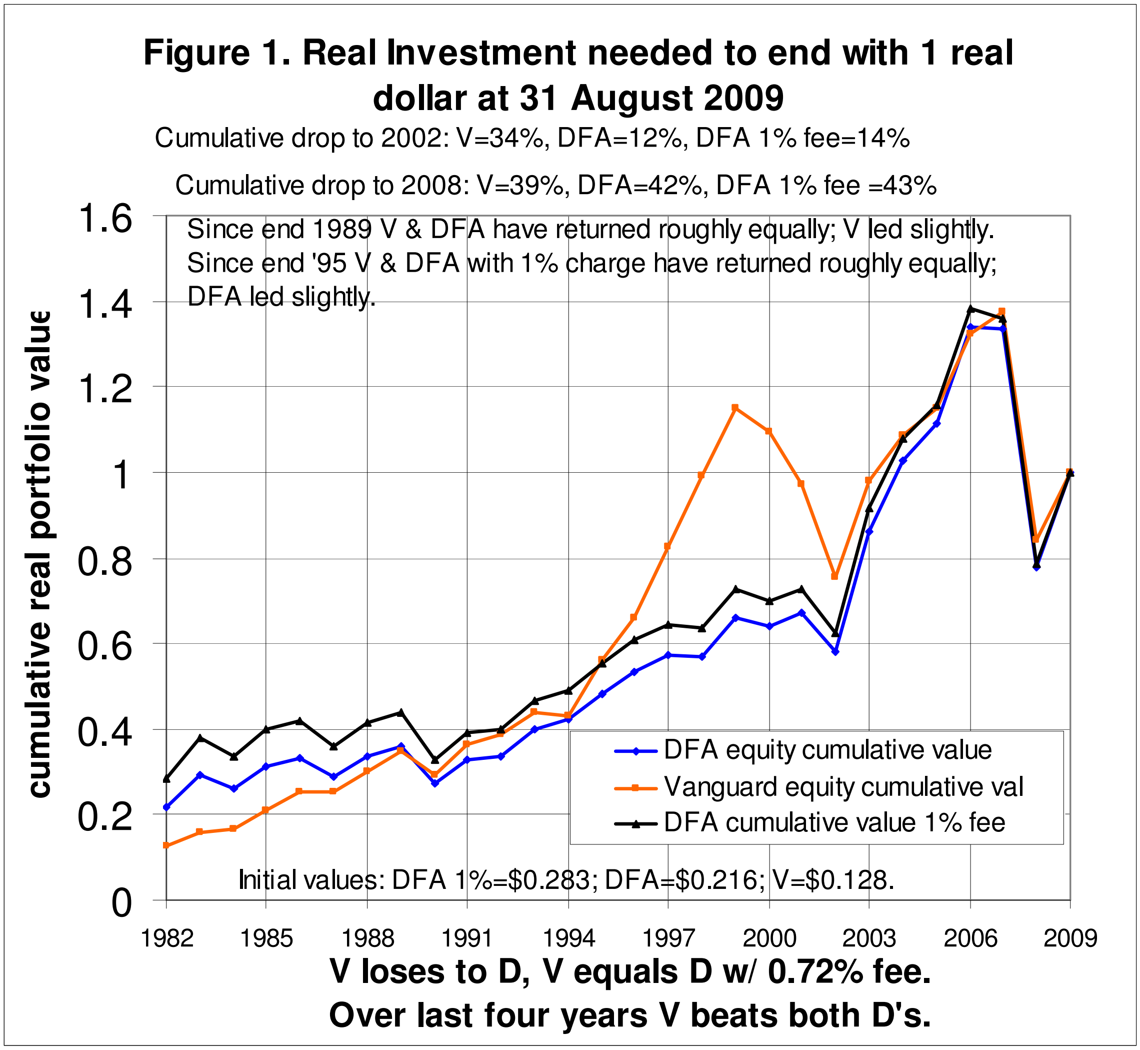
We also ask whether the portfolios recommended in Dan Wiener's *The Independent Advisor for Vanguard Investors* have outperformed the portfolios held by the average Vanguard investor. This supplements other analysis that Tower (2009a) has done on Wiener's newsletter.

Investigating style-adjusted performance is important for an investor who has selected the desired style and wishes to know which fund or company or portfolio would have provided the best performance within that style. Looking at the entire portfolios provided to clients by different companies or suggested by different advisors enables assessment of how clients have done. This is a function of the funds provided by the companies, the advice provided by the companies and their associated advisors, as well as the behavior of the clients themselves. If we want to answer the question: "Has Vanguard or DFA or WisdomTree done better by their clients?" analyzing the returns of the entire portfolios is the correct method. This is what we do here.

4.1.2 Vanguard versus DFA

All figures and analyses are adjusted for inflation. Thus all returns, values and standard deviations of return are real, not nominal. All data are drawn from Morningstar (2009). Performance is shown up to August 31, 2009.

Figure 1 considers three portfolios. It shows asset weighted cumulative value from the end of 1982 onwards. The end of 1982 is when the data for DFA starts. The curves are constructed so that all portfolio values on August 31, 2009 are $1. Thus they show how much money an investor must have in a portfolio at each date to reach $1 at August 31, 2009. All values are expressed in August 2009 dollars.



The orange line shows the cumulative real value of an investment in Vanguard's equity funds, excluding those with a high minimum investment: Vanguard's Admiral, Institutional, Institutional Plus and Signal shares. This exclusion served to focus the study on non-wealthy Vanguard investors. All equity funds were used including sector and international funds and ETFs. We were interested in analyzing performance of an investor with assets in a retirement account. Consequently, we excluded tax managed funds. To avoid double counting of assets we excluded the two Vanguard funds that are funds of funds.

The return is calculated by weighting the return of each mutual fund over the year by the assets in it at the beginning of the year. Thus the curve shows the performance of the average non-wealthy Vanguard equity investor.

The blue line shows the same for DFA equity funds. It excludes the DFA core funds, which are new and are considered in Figure 4. It also excludes tax-managed funds and bond funds. It ignores the transaction fees associated with rebalancing and advisory fees which an investor with DFA must pay.

Tower and Yang (2008) suggest these fees for most investors lie between 1.665% per year and 0.0156% per year. Fees depend on relationship with the advisor, how much money is invested, and who the advisor is.

From December 1982 through August 2009 the asset-weighted Vanguard equity portfolio beat the asset-weighted DFA equity portfolio by 1.96% per year, continuously compounded. That Vanguard beat DFA can be seen from the calculation that one would need to start out with $0.216 in DFA but only $0.128 in Vanguard equities to end up with a dollar on August 31, 2009. The average returns are plotted in Figure 3.

The black lines in Figures 1, 2 and 3 show the time path for a DFA investor assuming that an investor pays 1% of assets per year in advisor and transaction fees to invest with DFA

DFA suffered a slightly larger crash in 2007 and 2008 than Vanguard did, but Vanguard suffered a much larger crash during the period from the end of 1999 through the end of 2002, so it is not possible to make a strong statement about which portfolio was riskier. In fact, DFA has a slightly higher standard deviation of return (18.3%/year as opposed to 17.0%/year).

This same information as in Figure 1 is plotted on a log scale in Figure 2. This is a handy graph, because the slope of the curve is proportional to the rate of growth. Also, if one wishes to compare returns over any period it is necessary to just shift the curves up or down. This can't be done with the curves in Figure 1. Figure 3 plots real average returns. Real returns, continuously compounded over the entire period are Vanguard equity = 7.71%, DFA = 5.74%/year; DFA with a 1% charge per year = 4.73%/year. Continuously compounded returns are lower than average annual returns. They have the advantage that the continuously compounded return over several years is the average of the continuously compounded returns over the individual years.

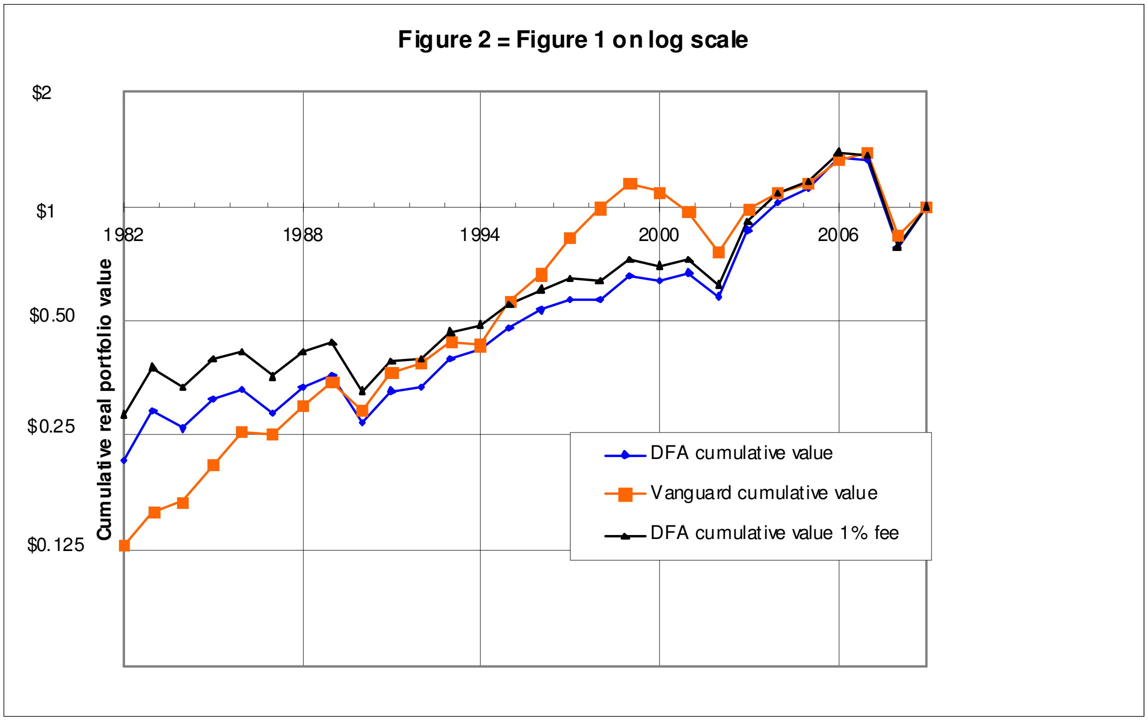


Figure 2 = Figure 1 on log scale
$2
$1
$0.50
$0.25
$0.125
1982
1988
1994
2000
2006
Cumulative real portfolio value
DFA cumulative value
Vanguard cumulative value
DFA cumulative value 1% fee

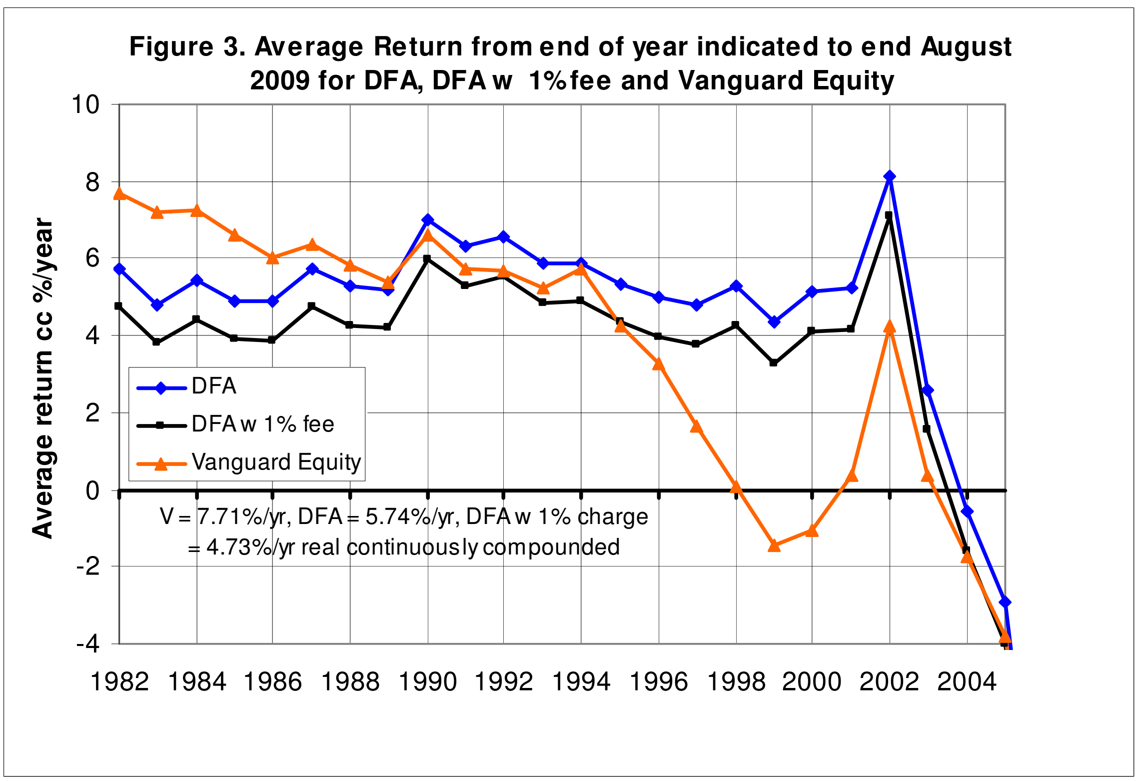
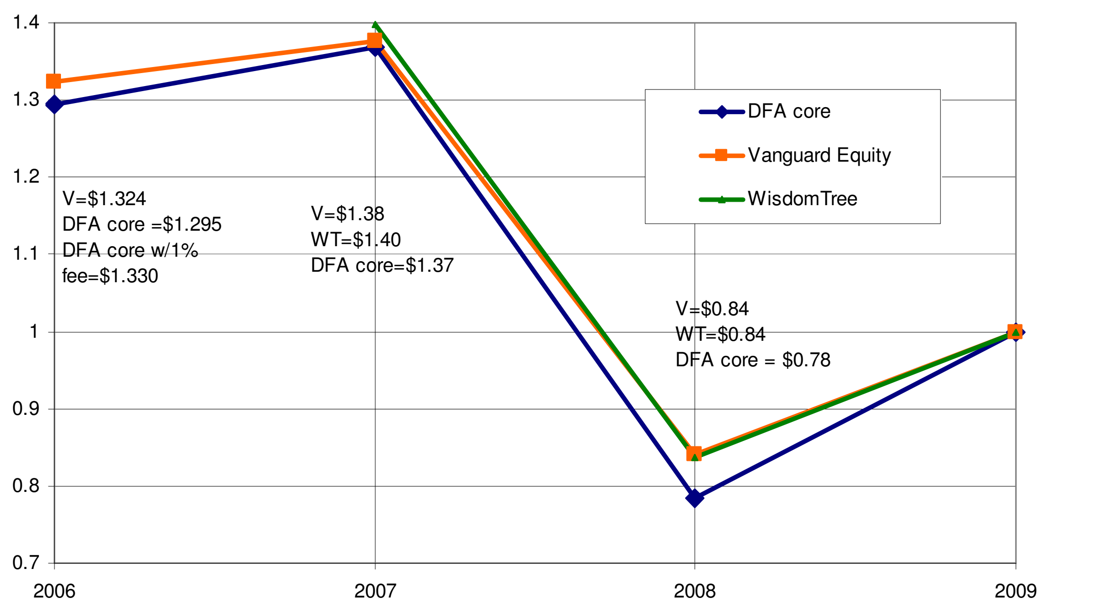


Figure 3. Average Return from end of year indicated to end August 2009 for DFA, DFA w 1%fee and Vanguard Equity
10
8
6
4
2
0
-2
-4
1982
1984
1986
1988
1990
1992
1994
1996
1998
2000
2002
2004
Average return cc %/year
DFA
DFA w 1% fee
Vanguard Equity
V = 7.71%/yr, DFA = 5.74%/yr, DFA w 1% charge
= 4.73%/yr real continuously compounded

4.1.3 Vanguard versus WisdomTree and DFA's Core Funds

DFA's core funds and WisdomTree's funds are both young. Morningstar presents data on WisdomTree only from the end of 2007. It presents data on the DFA core funds only from the end of 2006. The core funds weight portfolios according to market cap with the weights depending on characteristics of individual stocks, such as size and the extent to which they are value stocks. The cumulative real values of the Vanguard Equity, WisdomTree equity and DFA core portfolios are graphed in orange, green, and blue in Figure 4. The DFA core funds are made up solely of equities (and are referred to by DFA as portfolios). We calculate these portfolios' returns by weighting the return by assets in each fund at the beginning of each year as in our other calculations.

Figure 4. Cumulative Real Portfolio Values for Vanguard Equity, DFA Core Equity and WisdomTree Equity through End August 2009

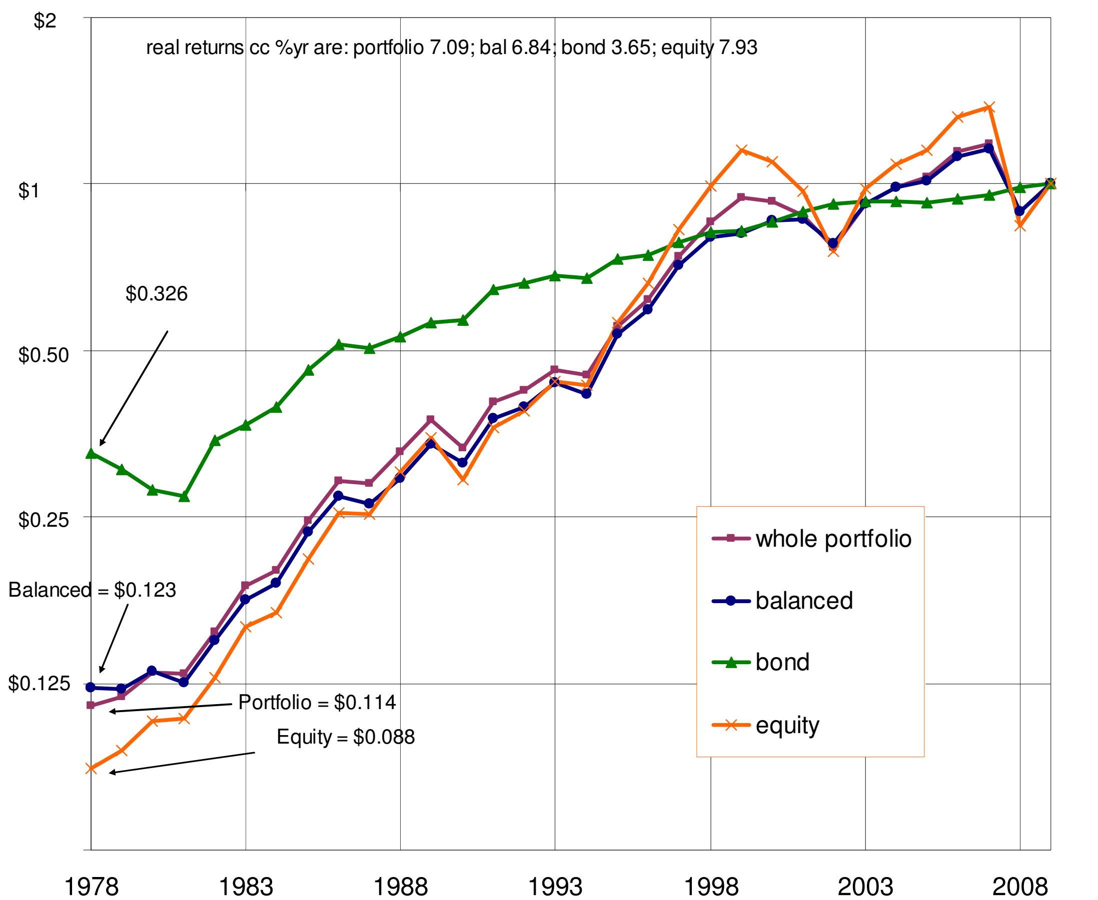


In real terms, $1.295 invested with DFA core at the end of 2006 or $1.324 with Vanguard or $1.330 with DFA and an annual 1% advisor and transaction fee becomes $1 at the end of August 2009. Thus, a 1% fee wiped out the DFA superiority. The numbers for the end of 2007 are $1.40 with WisdomTree, $1.37 with DFA core and $1.38 with Vanguard equity. Thus Vanguard out-returns WisdomTree. However, in the absence of advisor and transaction fees it under-returns DFA core over the 2 2/3 years since the end of 2006.

4.1.4 Vanguard

Figure 5 explores how the Vanguard portfolio has performed. The data start at the end of 1978, just after Vanguard's first fixed income fund was established. The green line shows the cumulative value for this bond portfolio. The orange line shows the same for the equity portfolio. The blue shows the same for the balanced portfolio (mutual funds which invest in a mix of stocks and bonds). The crimson line (crimson being the Vanguard color) shows the same for the entire Vanguard portfolio. In each case the performance figures are weighted by assets under management at the beginning of each year, and again we exclude Admiral, Institutional, Institutional plus, and Signal share classes as well as tax managed funds.

Figure 5. Cumulative real values for Vanguard investors (log scale)



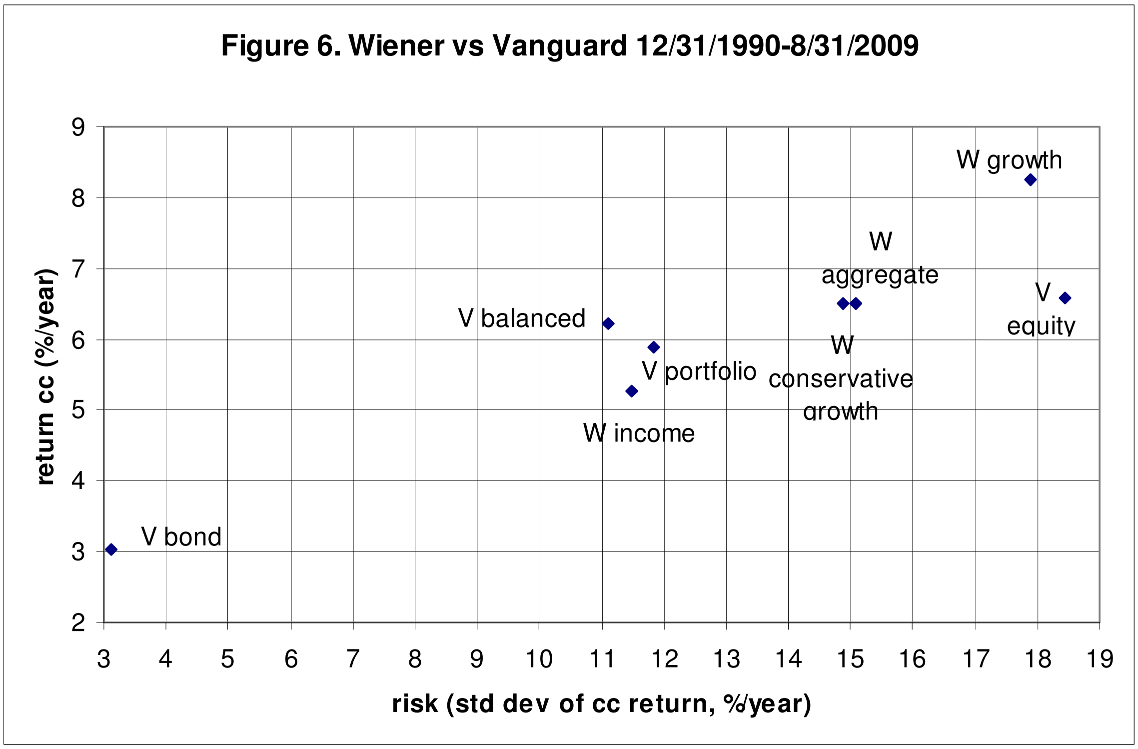
Returns from highest to lowest are balanced, equity, historical portfolio, and bonds.

We see that in real dollars, $0.326 invested in bond mutual funds, $0.123 invested in the balanced portfolio, $0.114 invested in the entire portfolio, and $0.088 invested in equity mutual funds grow to one dollar at the end of August 2009, again all in real terms.

4.1.5 Dan Wiener's *The Independent Adviser for Vanguard Investors*

The Bogleheads forum often features discussion of Dan Wiener's *The Independent Adviser for Vanguard Investors*. His advertising material compares his performance with that of the average Vanguard investor. Is this legitimate?

Figure 6 compares risk and return of various portfolios since the end of 1990. The data on Wiener's returns are taken from his newsletter. *The Hulbert Financial Digest* used to publish these, but it no longer does so. His Growth Index Model was excluded from this graph since data for that model only starts in January 1996. The three models included are the Growth Model, the Conservative Growth Model and the Income Model[25].



Two of the three Wiener models extant at the end of 1990 out-return the Vanguard portfolio. But this out-return comes at the cost of substantial risk. The Vanguard portfolio has an annual standard deviation of real return of 11.8% per year. Wiener's Growth Model is half again as big at 17.9% per year. In this diagram all returns are continuously compounded, and the standard deviation of return is calculated using annual continuously compounded returns. The Vanguard equity portfolio has a standard deviation of return (18.4%) that is slightly more than Wiener's Growth Model and a considerably lower return (6.6%/year as opposed to 8.2%/year). This is a more appropriate benchmark.

[25] For a small charge, one used to be able to purchase data on annual returns for each of Wiener's portfolio from HFD. Currently, one only finds the graph of cumulative value for the aggregate of Wiener's portfolios in the material provided by the HFD. That the data is hidden makes the HFD reports less valuable, as it hides the fact that Wiener's Growth Model has way out-returned his other models.

4.1.6 Wiener's Individual Models

For investors who wish to follow one of Wiener's individual portfolios, it is worthwhile to look at their individual performance. This is done in Table 1.

Table 1. The Wiener Portfolios

	Portfolio	Inception	Retn	SD of bench-mark Retn	Benchmark	RA comparison portfolio	Wiener superiority %/year cc	t	Prob luck
1	Growth	Jan-91	8.24	17.9	Growth	97% VE; 3% VP	1.67	1.19	24.7
2	Conservative Growth	Jan-91	6.52	14.9	Cons Gro	54% VE; 46% VP	0.2	0.21	83.4
3	Income	Jan-91	5.27	11.5	Income	10% VP; 90% VB	-1.02	-1.26	22.5
4	Growth Index	Jan-96	4.23	20.1	Equity	95% Gro Idx; 5% VP	-0.1	-0.17	87.0

Note: Retn is average return since inception cc %/year.
SD of Retn is standard deviation of return cc %/year.
RA comparison portfolio is the composition of the risk adjusted comparison portfolio.
VE is Vanguard equity,VP is entire Vanguard portfolio, VB is Vanguard balanced.
t is the value of the t test for significance of difference of mean returns.
Prob luck is the probability in % that the absolute value of the difference in returns between the two portfolios is as large or larger as that observed due to luck. It is a two tailed test.
Average Wiener superiority is 0.19 % per year.

Wiener's Growth Model has the same standard deviation of returns as a portfolio consisting of 97% of Vanguard's equity portfolio and 3% of Vanguard's entire portfolio, rebalanced at the beginning of each year. Wiener's Growth Model out-returns by 1.67%/year, continuously compounded. The probability that a deviation of this size or greater in absolute value would be due to luck is 24.7%. Thus, the probability that the outperformance of the Growth Model of this amount or greater would be generated by luck is half that, i.e. 12.3%[26].

The cumulative real returns for the Wiener Growth Model and its Vanguard risk-adjusted counterpart are shown in Figure 7. $0.293 invested in the Vanguard portfolio and only $0.215 invested in the Wiener Growth Model grow to $1 at the end of August 2009.

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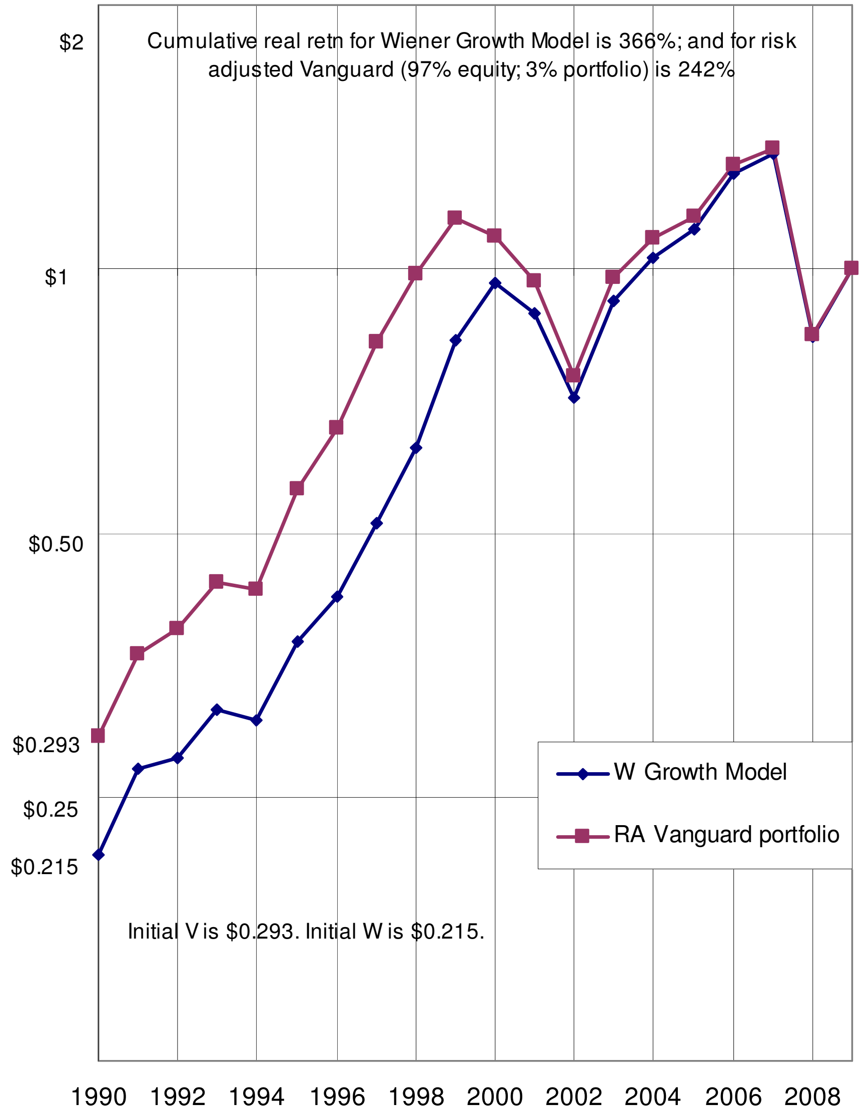
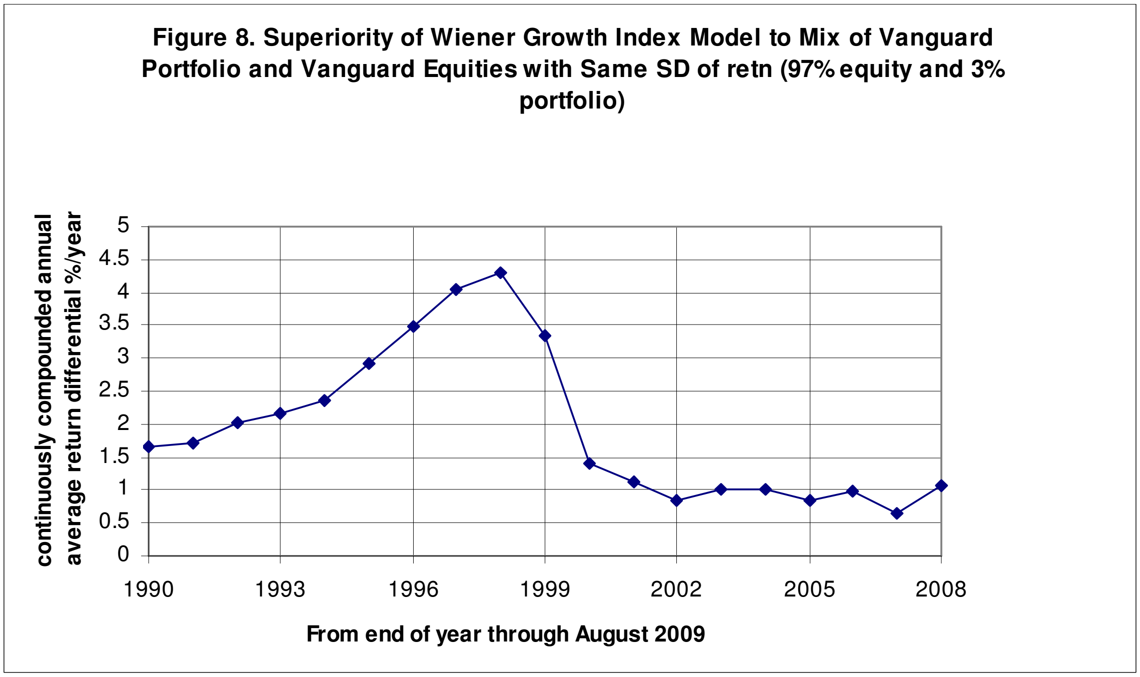
[26] Throughout the article our probability calculations use Microsoft Excel "t test: paired sample for means." For risk adjustment, we use Excel's solver program to find portfolios with a specified standard deviation of return. In calculating the probabilities we treat the 2009 returns up to the end of August as if they were whole year returns. In all other calculations we recognize that returns for 2009 through August apply only for the first 2/3 of 2009.

Figure 7. Cumulative real value of Wiener Growth portfolio and Vanguard risk-adjusted portfolio (log scale) to 8/31/2009



Risk adjustment keeps std deviations of real retns equal. Risk adjusted Vanguard portfolio is mix of Vanguard Portfolio and Vanguard Equities with Same SD of return (92% equity and 8% portfolio).

Figure 8 shows the average superiority of the Wiener Growth Model to its Vanguard risk-adjusted counterpart. From the fall of 1998 it outperformed by over 4.30% per year. From the Fall of 2002 it has outperformed by 0.85% per year. Thus Wiener's Growth Model was less harmed by the growth stock bubble than its risk-adjusted Vanguard counterpart. Much of the outperformance of Wiener's Growth Model comes from the End of 1998 through the trough of the stock market at the end of 2002. Thus he cushioned his investors from the collapse of the growth stock bubble. When the market is falling is a particularly important time to outperform, as the Wiener Growth Model did.



In fact if one excludes those four years, the Wiener Growth Model returned 0.365% per year less than its risk adjusted counterpart (real and continuously compounded). Thus the average superiority of the Wiener Growth Model over the years other than those of the growth stock peak and crash was -0.365% per year.

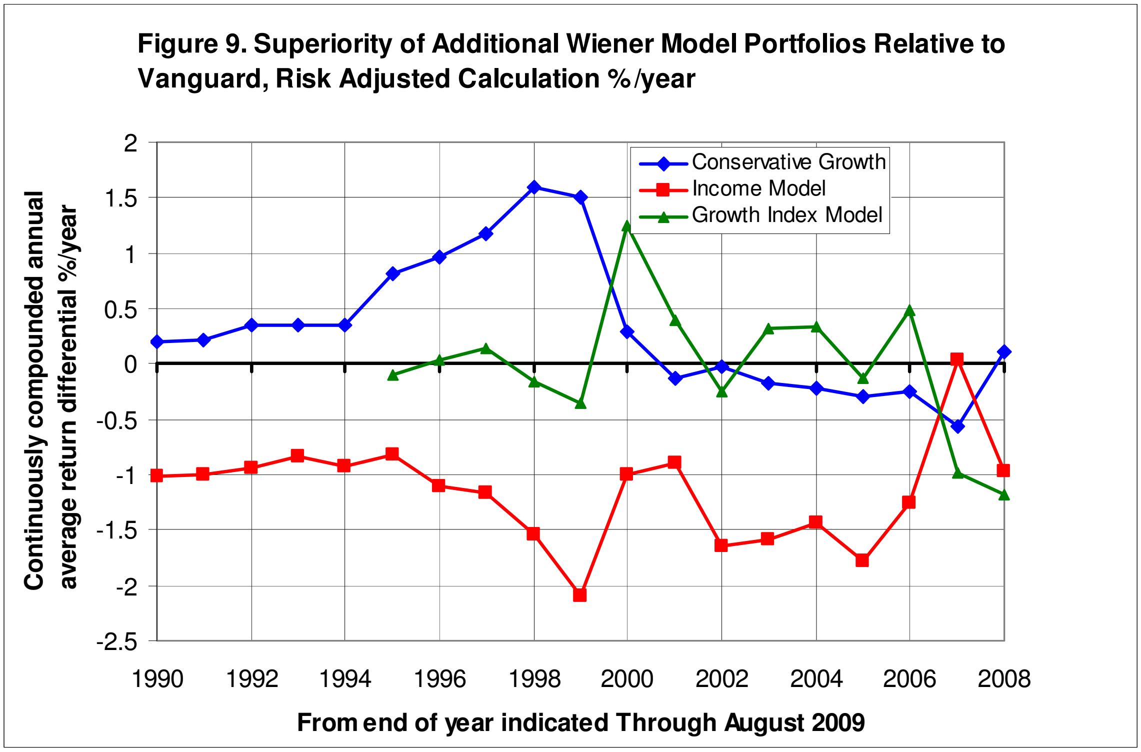
- From end 1990 through end 1998 Wiener's Growth Model under-returned the risk-adjusted Vanguard portfolio by 1.67% per year.
- From end 1998 through end 2002 it out-returned by 9.82% per year.
- From end 2002 through end August 2009 it out-returned by 0.85% per year.

Thus, its post 1998 performance has been much better than its earlier performance. Its post 2002 return differential is an impressive 0.85% per year, but does not match its out-return during the mid and latter part of the growth stock bubble.

Using the same method, we find from Table 1 that Wiener's Conservative Growth Model outperforms by 0.2%/year. This exceeds the 0.16% expense ratio of Vanguard's Total Stock Market Index fund. Wiener's Income Model has a lower standard deviation than the entire Vanguard portfolio. Thus we match its standard deviation with a blend of Vanguard's entire portfolio diluted with a large amount of Vanguard's balanced portfolio. The underperformance of the Income Model is 1.02%/year.

The Wiener Growth Index Model has a higher standard deviation than Vanguard's equity portfolio. Thus we match standard deviations by comparing Vanguard's equity portfolio with a blend of Wiener's Growth Index Model, diluted with some of Vanguard's entire portfolio. This risk-adjusted comparison shows Wiener's Growth Index Model to underperform by 0.10%/year, but the probability that such a large or larger deviation between the two portfolios could be caused by luck is 87.0%.

The average superiority of each of the other three Wiener models is discussed in Table 1 and graphed through time in Figure 9. These funds have not been nearly so successful, as the Wiener Growth Model.



The average of these outperformance figures for the four models is 0.19%/year. This seems small. However, if one expects the benchmark Vanguard portfolio to provide a real return of 5% per year in the future, this represents a 3.8% excess return.

The risk-adjusted return differential for the Wiener growth model is considerably larger than the risk-adjusted return differentials for the other funds.

4.1.7 The Wiener Growth Model versus two Vanguard Broad Indexed Portfolios

The *Hulbert Financial Digest* compares the return of investment newsletters with the return of the Wilshire 5000 index. For the Wiener newsletter, a more appropriate comparison is with portfolios of Vanguard funds that Vanguard investors are likely to find appealing.

One natural question is: How has the Wiener Growth Model performed relative to the Vanguard Total Stock market Index (VTSMX)? We have data for that fund beginning only in January 1993. For the two years prior to that we approximate its return by the mix, rebalanced each year, of the Vanguard 500 Index Fund (VFINX) and the Vanguard Extended Market Index Fund (VEXMX) which best tracks VTSMX after its inception. The Wiener Growth Model out-returns it, what we call the broad domestic indexed portfolio, by 2.55% per year, continuously compounded, and its standard deviation of real return (cc) is slightly lower (17.9%/year versus 18.9%/year). The t for the difference in mean return is 1.386, and the odds that luck would cause such a large or larger outperformance is 9.14%. This outperformance is consistent with Wiener's disdain for broad-based index funds. For an evaluation of whether this disdain makes sense from another perspective, see Tower (2009a).

When we compare the Wiener Growth Model with an internationally diversified broad indexed portfolio there is a larger difference. We assumed that the investor puts 30% of her portfolio into the Total International Stock Index Fund (VGTSX) and the rest into the stay-the-course domestic portfolio, rebalanced each year. Before it was established, we assume that the investor put her international funds into Vanguard's Emerging Markets, European and Pacific Index Funds, (VEIEX, VEURX and VPACX). We assume the mix of the three was that which subsequently best tracked the VGTSX. Prior to inception of the VEIEX, we assumed investment in European and Emerging Market Funds, with the portfolio weights calculated in the same way. The performance superiority of Wiener Growth is 3.02%/year, cc, (real returns, cc, of 8.24%/year for Wiener Growth versus 5.22%/year for Vanguard) with unchanged standard deviations of real returns. Here the t rises to 1.78 and the probability that luck would cause such a large or larger excess return falls to 4.95%[27].

4.1.8 The Advertising Material for *The Independent Adviser*

The advertising material for Dan Wiener's *Independent Adviser for Vanguard Investors* that arrived in Tower's mail box in October 2009 compares the returns for the "Average Vanguard Investor" with the Investor in "Dan's Growth Model Portfolio." It notes that from a start value at the end of 1990 of $100,000 by the end of 2008 the "Average Vanguard Investor" has turned his investment into $316,360, while the investor in "Dan's Growth Model Portfolio has turned his $100,000 into $613,246. It adds that the return of the growth model is 94% better than that of the AVI. That figure is the proportional difference between the end values. The Wiener Growth return is actually 137% greater than the AVI return. Had Wiener chosen to compare real returns, he could have reported a 236% margin of excess return. Ah the power of compounding a return differential! His calculation has the AVI's investment returning at a continuously compounded nominal rate of return of 6.40%/year and the growth model returning at a rate of 10.08%/year. Inflation continuously compounded over the period was 2.51%/year, which gives nominal returns of 3.89%/year and 7.47%/year respectively, for a continuously compounded return differential favoring Wiener Growth of 3.58%/year.

[27] Our domestic and internationally diversified broad index portfolios were beaten by Vanguard equity investors. The returns are 5.69 % per year, 5.22% per year, and 6.59% per year, respectively. This reflects well on Vanguard investors.

The return differentials we calculated for this period are for

- Growth minus the entire Vanguard portfolio: 2.05%/year,
- Growth minus Vanguard equity: 1.68%/year,
- Growth minus the Vanguard risk adjusted portfolio: 1.69%/year,
- Growth minus the Vanguard broad indexed domestic portfolio: 2.35%/year,
- Growth minus the Vanguard broad indexed internationally diversified portfolio: 2.97%/ year.

We presume that the differential is explained mainly by the exclusion from our calculations of some funds, particularly tax-managed funds, which have lower yields. We excluded certain other types of funds too as described earlier. Also, we weighted returns by assets at the beginning of the year, which may be different from the system that Wiener used.

The advertising material notes that so far this year the average Vanguard investor is up 12.1%, while the Wiener Vanguard Growth Model is up 21.3%.

Through the end of August 2009, our figures for nominal arithmetic returns are quite similar:

- 21.3% for Wiener Growth,
- 13.80% for the entire Vanguard portfolio,
- 13.98% for Vanguard's balanced fund portfolio and
- 20.62% for Vanguard's equity portfolio.

As shown in Figure 6, Vanguard's equity portfolio has been more risky than Wiener's Growth Model. The other two Vanguard portfolios have been less risky than Wiener's Growth Model.

The advertising material does not discuss the other three portfolios offered by the newsletter.

4.1.9 Conclusion

- The DFA equity portfolio has not consistently outperformed the Vanguard equity portfolio. Over the entire life of the DFA equity portfolio, its return is less than that of the Vanguard equity portfolio, even without adding in advisor and transaction fees for the DFA portfolio. However, for the period of the start of the growth stock bubble (end of 1995) through August 31, 2009, DFA, even with an advisor and transaction fee of up to 1%/year, out-returned the Vanguard portfolio.

- How has Vanguard matched up with two recent innovations in enhanced indexing? From the end of 2007 through the end of August 2009, Vanguard's equity portfolio has out-returned WisdomTree's equity portfolio by a hair. Since the end of 2006, Vanguard's equity return has fallen short of the DFA Core Equity return, although adding in a 1% annual fee for DFA reverses the ranking.

- The balanced funds of Vanguard have had a slightly lower average return since the inception of Vanguard's first bond fund than the entire Vanguard portfolio or the Vanguard bond portfolio. The standard deviation of return of the balanced portfolio since the end of 1982 (10.5%/year) is quite close to that of the Vanguard portfolio (11.0%/year).

- Two out of four of the Wiener portfolios out-performed Vanguard when the comparison adjusts for risk, and the average risk-adjusted outperformance is 0.19%/year. This is substantial compared with Vanguard's expense ratios. Wiener's star is his growth portfolio which has outperformed its risk-adjusted Vanguard counterpart by 1.67%/year. It has also outperformed a broad indexed, internationally diversified Vanguard equity portfolio by 2.87% per year.

- Prior to the end of 1998 Wiener's Growth Model under-returned its risk-adjusted Vanguard benchmark. Much of the outperformance of Wiener's Growth Model comes from the end of 1998 through the trough of the stock market at the end of 2002. Thus he cushioned his investors from the collapse of the growth stock bubble. Since then he has out-performed the risk-adjusted Vanguard benchmark by 0.85% per year.

- The Fall 2009 advertising material for Wiener's newsletter lauds the performance of his Growth Model, without mentioning the performance of his other funds. Also, its comparison of the performance of the Growth Model is with that of the average Vanguard investor. Based on his data, we calculate that he outperformed from the end of 1990 to the end of August 2009 by a rate of 3.68% per year. The superiority to our risk-adjusted benchmark is the smaller but still impressive 1.67% per year, and its superiority to the broad indexed, internationally diversified Vanguard equity portfolio is 2.97% per year.

4.1.10 References

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At the conclusion of Ed's presentation at BH-8, Bill Bernstein made an observation. He said that he has always been puzzled why balanced funds did so well. Now, he realized that the two funds, Wellington and Wesley, are value-oriented, which helps their good performance.

4.2 Panel Q&A

Panel members:

- Bill Bernstein ("**Bill**")
- Laura Dogu ("**Laura**")
- Rick Ferri ("**Rick**")
- Taylor Larimore ("**Taylor**")
- Mel Lindauer ("**Mel**")
- Sue Stevens ("**Sue**")
- Ed Tower ("**Ed**").

Question: This question is from the Paris chapter coordinator. Should an average investor worry about the currency risk, and if yes, what to do about it?

Bill: Have some stock allocation to unhedged foreign *equity* funds. They are uncorrelated to the economy, because when their value goes down their earnings go up, and vice versa[28]. On the other hand, unhedged foreign *bond* funds are a bad idea, because they do not provide the same moderating effect.

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[28] Comment by Paul Stratton: All of Vanguard's, and everyone else's, foreign equity funds are unhedged except for one or two managed funds.

Ed: There is Barry Eichengreen's paper[29] describing how when countries got off the gold standard after the Great Depression and let their currencies fluctuate they did really well.

Question: This question is to Rick. Have you made any significant changes in your clients' asset allocation?

Rick: Significant? No. People who need to use risk tolerance questionnaires should have answered a questionnaire on 9 March 2009, when the markets were at their lowest levels. That's when you determine your asset level with which you are still able to sleep, and you never go below it. It is easy to be brave in a bull market.

Sue: I agree with Rick. I did not do anything significantly different with my clients, but I stepped up communications. Advisors need to listen. I have heard stories where people were discouraged, because their advisors did not speak to them. Best advisors were listening throughout the crisis, they were using email, videos, and any other means -- they needed to be there.

Taylor: I have been through many bear markets now, and they don't bother me anymore. Older people have less to lose, so remember to keep your age equivalent in bonds.

Question: What do you think about a Roth conversion in 2010 and paying taxes in 2011-2012?

Sue: I will be contributing to Morningstar where Roth conversion is one of the greatest topics. Remember that those with the AGI [Adjusted Gross Income] *below $100k* can make a conversion this year. Also, remember that people can do *partial conversions*. One reason for making a conversion is if you think that *taxes will go up* in the future. If you believe so, you may prefer paying taxes now, while they are lower. This is also a consideration for people with significant retirement balances who will be facing *large RMD* [Required Minimum Distributions].

You also have to think how you will pay for the conversion. You should use some other money -- *not* the IRA money -- to pay taxes.

Rick: There is also an impact of one's age on the conversion. Those who are over the age of 70 take the RMD first and then they do the conversion. People under the age of 59.5 can convert; there is no need to wait until 59.5.

Mel: Look at your tax bracket, and if you are comfortable in that bracket, convert within the bracket.

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[29] http://www.econ.berkeley.edu/~eichengr/research.html

<u>Question</u>: This question is *from* Rick Ferri. Jack Bogle advocates age in bonds as asset allocation. What do you think?

<u>Mel</u>: That's just a guide. Some need more, some need less.

<u>Sue</u>: This is a good rule of thumbs. However, there are some extenuating circumstances, e.g., when enormous amounts of money are involved, where people do not need to follow this rule.

<u>Laura:</u> This rule helps even more with the psychological management than with the asset management.

<u>Bill</u>: I agree completely with Sue. If you are Warren Buffet, you can be 99% in stocks and still be spared from eating at McDonalds. I also agree with Laura, even though for some, even age in bonds may be too aggressive.

<u>Rick</u>: I am writing an article about asset allocation based on people's age[30], where I look at people of different ages and consider if "age in bonds" is appropriate for them. For example, for *young* people with no money, low income, etc., age in bonds (i.e., ~80% in stocks) works well. In the *middle age*, there is a wider distribution, and the things Sue talked about play a greater role here. Once people are near their *retirement age*, other things come into play. For example, a husband and wife may have a large age difference. Or perhaps people have all the money they will ever need. For example, if you have $3M and you need only $1M, you can allocate money as follows:

- $1M – your age in bonds, with the allocation 40/60 (stocks/bonds)
- $2M – your children's age in bonds with the allocation 70/30 (stocks/bonds)

Great question, by the way☺.

<u>Question</u>: At what age should one start taking Social Security?

<u>Mel</u>: Today's USA Today had an article that the number of Social Security applicants is up 19%, because of the economy. Apparently, people are applying for Social Security earlier and use it as an emergency fund. Some people take it at the age of 62, because they don't want to tap into other resources such as 401(k) and IRA. When you consider your own start of Social Security, consider the respective ages of you and your spouse. There is no single answer, just as with the bond allocation.

<u>Sue</u>: The chapter on Social Security in "<u>The Bogleheads Guide to Retirement Planning</u>" is really good. For example, when I was reading this chapter I learned about the Social

[30] An article "An Age-Old Question" by Craig L. Israelsen and Richard A. Ferri was published in the October 2009, issue of Financial Planning, [PDF] of which is available here http://www.portfoliosolutions.com/assets/attachments/Allocation_Age_FP_Oct_09.pdf

Security “pay-back” option. I have a client who wants to do a pay-back; they did a calculation and it would work well for them.

Bill: There is another approach described by Alan Klein. The higher earner in the family files for Social Security at the age of 62 and then immediately declines. The lower earner then receives a half of that amount. At the age of 70 they make another change. This is a complex strategy, but it works well for couples.

Mel: When you do pay-back there is no interest on the pay-back. However, most people working for the Social Security Administration do not know how this works. Therefore, filing is rather complex. As more people start taking advantage of this approach, SSA will get more efficient in processing it.

Follow-up question: How do the taxes work with the pay-back option?

Mel: You get a refund for the overpaid taxes, but again, the administration of this is difficult.

Question: With the expanding budget deficit should we expect an increase in inflation?

Mel: If you have bought I-bonds when I told you, you would not have to worry about the inflation ☺. Now, look into TIPS [Treasury Inflation Protected Securities]. If you have more money than you need to live, load up on TIPS.

Taylor: Read today’s paper. Mortgages are lower than at any time in recent history. Only astrologists can predict whether there will be an increase in inflation.

Bill: I recommend canned food and handguns☺.

Rick: An anticipated 10-year inflation is already built into all investment classes. Bill Gross anticipates 2% GDP growth. We will not see a lot of inflation soon. Should growing deficits generate inflation? Nobody really knows.

Bill: Keep your bonds short even if you have to give up some yield.

Question: This question is about TIPS. When should one own them in a taxable account? Is it appropriate for someone in a high-tax bracket? How about high-tax state, where TIPS are exempt from the state and local taxes?

Rick: I talked about this with Paul. For example, if you live in California, it may make sense to keep Treasuries in taxable account -- whether these are TIPS or other Treasuries.

Sue: I wrote an article on when to put TIPS into a taxable account.

Mel: Here is another side of holding TIPS in a taxable account. I did an in-kind transfer of TIPS from my IRA to my taxable account as part of my RMD, and Vanguard initially did not know how to handle it. After finally getting the in-kind transfer done, I received a correct Form 1099, but the online cost basis shown by Vanguard was incorrect, leading to what could be ~$500 in extra taxes in my taxable account. Vanguard blamed it on Pershing, and said that they would correct it when they took over the brokerage services from Pershing. Vanguard did eventually change the cost basis number, but it still was incorrect. After persisting through various levels at Vanguard, I eventually showed them that there was a problem with Vanguard's database related to TIPS adjustments.

Your cost basis is a moving basis, e.g., your $20k cost basis changes based on the inflation or deflation. The Treasury performs inflation adjustments every day, but Vanguard only makes adjustments to your online cost basis every six months. This is a real-life experience.

You *can* do an in-kind transfer from a tax-deferred account to a taxable account, but you may have to talk to several people at Vanguard before you find someone who understands how to do this.

Follow-up question: Bill, when you emphasize short-term bonds, this does not apply to TIPS, right?

Bill: Correct; with TIPS you can go long.

Bill: Based on my yesterday's presentation, consider Vanguard's Corporate Bond ETF.

Rick: Will you buy ETF?

Bill: Advisor-based clients are eligible to purchase Signal-Class shares, but since Investor- and Admiral-Class shares will not be initially available, regular investors are not and they may consider the ETF.

Rick: I don't like bond ETF, unless you buy Treasury ETF; otherwise, you have a tracking error. With corporate bonds, in the current credit crunch, corporate bonds do not trade much and there are large fluctuations. And so bonds do not trade, while ETFs do, and there is no way to arbitrate. For example, there could be 800 bonds in a fund, but only 40 bonds in the basket, and you cannot arbitrate because there is a problem with liquidity. Therefore, I recommend buying only open bonds. Treasury ETFs are ok.

Question: What bond durations do you use?

Rick: Short-term bonds are liquid money that may be needed in 1-2 years. If you need money in about 5 years, consider intermediate term bonds. I don't buy long bonds at all.

<u>Follow-up question</u>: Are short-term bonds much riskier than money market funds?

<u>Bill</u>: If you use short-term bonds with 2-year duration, a 5% increase in interest rates will cause a 10% loss. More money has been lost in seeking bond yields than in equities.

<u>Follow-up question</u>: Is not it also an IRS nightmare to use short-term bonds for liquid investments?

<u>Bill</u>: In Vanguard this is not a problem, because they track it for you and send Form 1099.

<u>Mel</u>: I use the bulk of my liquid money in short-term bond funds and a smaller amount in Prime Money Market, which I use as my primary checking account. Once or twice a year, as needed, I do a transfer from the short-term bond fund to the MM account. This minimizes the number of taxable transactions.

<u>Sue</u>: Jack uses a short-term tax-exempt account, but you cannot write checks there. This account earns ~3% after tax, in comparison with ½% for Prime MM.

<u>Question</u>: I am a Vanguard advocate, but why would I keep money in a MM account that pays 1.4% if I can get a CD [Certificate of Deposit] that pays 3%?

<u>Sue:</u> Cash is one of the greatest issues now. I had a meeting with Schwab. There is a lot of movement behind the scenes, e.g., to create new products that are FDIC insured. FDIC is important, because they are now in the red. I agree with Bill that one should not chase the yield, but if you have a lot of cash, you have to do something with it.

<u>Question</u>: Where should I keep cash for six years for my children's school?

<u>Sue</u>: If you are worried, keep the money in a MM fund.

<u>Mel</u>: Split between MM and short-term bonds.

<u>Rick</u>: My daughter is a college senior now, and all this time we kept the money in the Vanguard short-term credit fund, which is an option for getting slightly higher income.

<u>Bill</u>: Do the Pascal's wager and consider the consequences of your choices. For example, you may put money into bonds to get slightly higher earnings, but if inflation spikes you may lose a lot of your principal.

Question: Bill, are you going to update your "Intelligent Asset Allocator[31]"?

Bill: No. I don't write the same book twice.

Question: Are you concerned about the value of the dollar?

Bill: I believe in holding 30% of the equity allocation in foreign stocks. You can worry about the opposite problem, i.e., that the dollar will appreciate and your foreign funds will collapse.

Rick: 30% of the U.S. earnings come from overseas sources. We may see an increase in real earnings, because of the overseas earnings.

Question: Should Vanguard's Target retirement funds be more conservative?

Rick: These funds did not meet their targets. There are some new ideas, e.g., "to" or "through" funds. "To" funds may, for example, target a college date. "Through" funds may target those who are planning on working through their retirement date.

Mel: I was disappointed when Vanguard changed target allocations. People are questioning the change, because they have a higher stock allocation than they previously had. Vanguard was forced to do this to be more competitive.

Taylor: Bogleheads should look into the asset allocation and ignore the target date.

Question: My friends are buying real estate, because they don't want to buy stocks. Should they buy REITs [Real Estate Investment Trust] instead?

Sue: If you don't want to fix toilets in the middle of the night, do not buy Real Estate.

Mel: I would rather buy REITs.

Bill: RE is not an investment, it is a job. Commercial RE has a lower correlation with the stock market than REITs. People who are good with RE and good with investments are usually different people.

Question: Taylor, do you consider your pension a part of your asset allocation?

[31] Available at Amazon.com: http://www.amazon.com/Intelligent-Asset-Allocator-Portfolio-Maximize/dp/0071362363/ref=sr_1_1?ie=UTF8&s=books&qid=1256530472&sr=1-1

Taylor: I have a Federal pension, social security and a couple of annuities. Pat and I can live comfortably on this income. For this reason we can afford more portfolio risk than our age in bonds would indicate. If you have more than $1M you may worry more about its capital distribution than income.

There is a good chapter in the "The Bogleheads' Guide to Retirement Planning" on estate management. There are some significant tax implications, and one may need an advisor.

Rick: Pensions are different. They are illiquid, just like the Social Security annuities are. You don't have any control over this money. A company may go out of business, and the Pension Benefit Guaranty Corporation (PBGC) would take over. PBGC may not pay the entire amount. Also, many pensions do not have inflation adjustment. If you count pensions as an equivalent of fixed income, discount them by 50%.

Sue: If you count pensions as fixed income, the rest of your portfolio would be too risky. Advisors will load you with emerging markets. I agree with Rick about the discounting factor.

Bill: I agree with previous statements. If you need $60k for living expenses and you have $30k of Social Security, you could annuitize the remaining $30k. A simpler -- and a more sensible – approach is to design your portfolio so that it would return $30k.

Question: How to convince my sister to leave Merrill Lynch?

Ed: Two years ago, I had a student who got an internship with Merrill Lynch in Raleigh, NC. Her job was to determine which asset managers outperformed others in the past and to assess whether they were beating the indices.

It turned out that they incorrectly used indices in their calculations. Everybody underperformed indices; those advisers who did well one year did poorly the next year. On top of that, they charged enormous fees. Merrill Lynch was unperturbed that they underperformed.

Laura: Sadly, you won't get your sister out. People just don't listen. You still should try. Every once in a while, send her links; send her a Bogleheads book.

Start with your children; you have a better chance with them than with your sister. This is a common problem, and it is frustrating for all of us.

Mel: Family dynamics are complex and frequently end up in a strong argument. When a student is ready the teacher will arrive. If they ask, provide information. Take advantage of any opportunity when they are interested. Don't just tell them that they are wrong.

Laura: Point them to other good advisors. Some people are just not interested in doing investing themselves.

Bill: Charles Ellis has pointed out 40 years ago the futility of active management. His doctor gave him a health advice. In return, Ellis offered the doctor to help with his investments, but the doctor refused. And so all Ellis' friends refused his investment help. Most people just won't listen. They don't listen to me, but I feel much better, because they did not want to listen even to the great Charlie Ellis.

Rick: Local brokers write articles, and then they have an ad for something they sell just below the article. I offered to write an investment article and provided my credentials, but the newspaper refused responding "Thanks, but no. We are already well covered in this area."

Mel: I have the same story. In a place where I used to live, real estate people wrote articles about real estate for a local paper. They were ignoring what was going on in the rest of the world with the real estate, because realtors heavily advertised in this publication.

Ed: Last year at BH-7 I was interviewed by Morningstar. I completed a study on earnings before and after subtracting expenses. By far, most funds underperform indices *even before subtracting expenses*.

Question: If one has to invest a large sum for a long term, and the choices are:

a) TSM, Admiral shares
b) ETF
c) Tax-managed capital appreciation,

Rick, what would you recommend?

Rick: It does not matter much. You can use ETF if you buy it with a low commission, e.g., from Schwab, if you have a large sum of money. Fees on Admiral shares are similar to ETFs.

Taylor: In bear markets I lost at least 1% tax-loss harvesting. Considering that there is a 1% penalty for selling tax-managed shares within 5 years, I would not buy this tax-managed fund again.

Question: Some people say that stocks become riskier with time. What do you think?

Bill: Stocks do become riskier with time. People confuse annual returns with long-term returns. People make an argument that if stocks were getting less risky, options pricing would reflect that.

Rick: The "Dow 36,000[32]" book made a claim that there was no risk in stocks on a long run. John McCain hired its author, James Glassman, as his economic advisor.

Ed: Mark Kritzman's "Puzzles of Finance[33]" is a fun book. For example, how would we invest if we knew that if our portfolio went down 10% our spouse would divorce us.

Question: What asset allocation should I have if my daughter is in Virginia Tech and I need to withdraw $15k per year?

Rick: 100% cash.

Taylor: I agree.

Question: A retiree on Social Security needs an additional $10k per year from the assets of $1M, i.e., about 1% of the assets. What his asset allocation should be?

Mel: This is a personal decision. In his book "The Intelligent Asset Allocator", Bill Bernstein reported that a 100% bond portfolio is riskier than one with some stocks.

Bill: This depends on the duration of the bonds. Before, I looked at long bonds. Now, I consider that with short bonds, I can have fewer stocks. Consider what you need this money for, e.g., for inheritance, for medical needs, etc.

Rick: At the Forum, people ask you follow up questions and become more precise. Ask this question in the Forum, and people will help you with more details

Sue: A good question to ask would be about this person's medical insurance.

Question: Considering Japan's demographic problems, should one invest in a Pacific fund without Japan?

Bill: There is a good correlation between economic growth and equity returns, but it is a negative correlation.

Laura: Also don't confuse population demographics with the economy. Some African countries have very young population but poor economies.

Rick: China is the next Japan. Don't discount Japan.

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[32] Available at Amazon.com: http://www.amazon.com/Dow-36-000-Strategy-Profiting/dp/0609806998/ref=sr_1_1?ie=UTF8&s=books&qid=1256533470&sr=1-1
[33] Available at Amazon.com: http://www.amazon.com/Puzzles-Finance-Practical-Remarkable-Investment/dp/0471228842/ref=sr_1_1?ie=UTF8&s=books&qid=1256533601&sr=1-1

Question: Is this a dangerous time to allocate money to bonds?

Rick: It could be.

Mel: We will tell you next year.

Question: What is the best lazy portfolio for the long term?

Mel: There are many responses in the Bogleheads Forum about this.

Taylor: There are many good lazy portfolios.

Rick: TSM/TBM 50/50. A more complex portfolio may add another 0.5% to the return and possibly reduce the risk, e.g., by adding International funds, REITs, etc.

Laura: A lazy portfolio is good, because it helps to stay the course.

Question: At what portfolio size should one do tax harvesting?

Rick: You should absolutely do tax harvesting. Use different funds such as TSM and S&P500, so that you could go in and out without waiting for 30 days. If you take a loss and don't have offsetting gains you can apply $3k against your ordinary income.

Taylor: Note that tax loss harvesting applies only to taxable accounts.

Sue: A lot of people sit on a lot of losses. Tax rates are likely to go up in 2011. You can take tax gains without tax liability with these accumulated losses.

Question: What advice do you have for an investor who have been investing since 1998 and did not experience drops of 2001 and 2008?

Laura: Perhaps the portfolio is too small? Keep doing what you have been doing.

Question: How to differentiate between investing and hoarding?

Bill: This is a psychological question. It depends on who raised you. Larry Kotlikoff's concept is that of over-saving (under-consuming). You may end up with a lot of cash that could be spent earlier. See "Spend 'Til the End: The Revolutionary Guide to Raising

Your Living Standard--Today and When You Retire[34]" by Laurence J. Kotlikoff and Scott Burns. But … you cannot predict your returns. Bernstein's law: save as much as you can for as long as you can, until you die.

Question: Some people like TBM [Total Bond Market], because it includes MBS [Mortgage Backed Securities]. Others recommend putting the entire bond allocation into intermediate term bonds. What do you recommend?

Taylor: TBM is almost ideal for most investors. It has a low expense ratio. TBM has short-term and long-term good quality bonds. When you buy just intermediate-term bonds you lose this diversification.

TIPS are a good second bond fund. It's best to use a tax-deferred account for holding taxable bonds.

Question: Do you recommend buying individual TIPS or TIPS funds?

Mel: As a general rule, the more money you are investing, the more advantageous it is to hold individual bonds. For Vanguard Flagship clients, there is $0 cost when buying TIPS at auction. With TIPS funds, it is easier to get in and out. Recently, TIPS rates spiked to 3% real. You don't want to pay broker's commissions.

Bill: Mel's concept is correct. You want inflation protection, and for that you need long TIPS, whereas TIPS funds have a lower duration.

Question: Is it true that when Jack Bogle was an intern he learned from a coworker that "nobody knows nothing"?

Mel: Jack got it right.

Sue: Agree, and particularly, watch out for a TV advice.

Rick: Even the last two Chairmen of the Federal Reserve did not know what was going to happen. "If everybody knows it, it is not worth knowing."

[Adjourned]

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[34] Available at Amazon.com: http://www.amazon.com/Spend-Til-End-Revolutionary-Standard-Today/dp/B002KE46S6/ref=sr_1_1?ie=UTF8&s=books&qid=1256534950&sr=1-1