"Rather than listen to the siren songs from investment managers, investors—large and small—should instead read Jack Bogle's The Little Book of Common Sense Investing."

-WARREN BUFFETT



COMMON SENSE INVESTING

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

10th ANNIVERSARY EDITION | UPDATED & REVISED

JOHN C. BOGLE

Founder and former CEO of the Vanguard Mutual Fund Group



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2017 *The Little Book of Common Sense Investing:*

10th Anniversary Edition | Updated & Revised

THE LITTLE BOOK OF

COMMON SENSE INVESTING

The Only Way to Guarantee Your Fair Share

of Stock Market Returns

10th Anniversary Edition | Updated & Revised

JOHN C. BOGLE

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To the memory of the late 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. While he departed this life in 2009, he remains my mentor, my inspiration, my shining light.

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Introduction to the 10th Anniversary Edition

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

Loser's Game.

SUCCESSFUL INVESTING IS ALL about common sense. As Warren Buffett, the Oracle of Omaha, has said, it is simple, but it is not easy. Simple arithmetic suggests, and history confirms, that the winning strategy for investing in stocks 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 these businesses generate in the form of dividends and earnings growth.

The best way to implement this strategy is indeed simple: *Buy a fund that holds this all-market portfolio, and hold 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 the U.S.

stock market (or any financial market or market sector). 1 The traditional

index fund (TIF), by definition, basically represents the entire stock market basket, not just a few scattered eggs. It eliminates the risk of picking individual stocks, the risk of emphasizing certain market sectors, and the risk of manager selection. Only stock market risk remains. (That risk is quite large enough, thank you!) Index funds make up for their lack of short-term excitement by their truly exciting long-term productivity. The TIF is designed to be held for a lifetime.

The index fund eliminates 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. It is a book about why long-term investing serves you far better than short-term speculation; about the value of diversification; about the powerful role of investment costs; about the perils of relying on a fund's past performance

and ignoring the principle of *reversion* (or regression) to the mean (RTM) in investing; and about how financial markets work.

When you understand how our financial markets actually work, you will see that the index fund is indeed the only investment that essentially guarantees that you will capture your fair share of the returns that business earns. Thanks to the miracle of compounding, the accumulations of wealth that are generated by those returns over the years have been little short of fantastic.

The traditional index fund (TIF).

I'm speaking here about the traditional index fund. The TIF is broadly diversified, holding all (or almost all) of its share of the \$26 trillion capitalization of the U.S. stock market in early 2017. It operates with minimal expenses and with no advisory fees, with tiny portfolio turnover, and with high tax efficiency. That traditional index fund—the first one tracked the returns of the Standard & Poor's 500 Index—simply owns shares of the dominant firms in corporate America, buying an interest in each stock in the stock market in proportion to its market capitalization, and then holding it forever.

The magic of compounding investment returns. The tyranny of compounding investment costs.

Please don't underestimate the power of compounding the generous returns earned by our businesses. Let's assume that the stocks of our corporations earn a return of 7 percent per year. Compounded at that rate over a decade, each \$1.00 initially invested grows to \$2.00; over two decades, to \$4.00; over three decades, to \$7.50; over four decades, to \$15.00, and over five decades, to \$30.00. 2

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 wealth, a positive-sum game for its owners.

Investing in equities for the long term has been 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 market 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 around two percentage points per year.

Applying that figure to the annual return of 9.1 percent earned over the past 25 years by the Standard & Poor's 500 Stock Index, your annual return has likely been in the range of 7 percent. Result: investors as a group have been served only about three-quarters of the market pie. In addition, as explained in Chapter 7, if you are a typical investor in mutual funds, you've done even worse.

A zero-sum game?

If you don't believe that return represents what most investors experience, please think for a moment about "the relentless rules of humble arithmetic"

(Chapter 4). 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 investors are average. For each percentage point of extra return above the market that one of us earns, 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.*

A loser's game.

As investors seek to outpace their peers, winners' gains inevitably equal losers' losses. With all that feverish trading activity, the only sure winner in the costly competition for outperformance is the person who sits in the middle of our financial system. As Warren Buffett recently wrote, "When

trillions of dollars are managed by Wall Streeters charging high fees, it will usually be the managers who reap outsize profits, not the clients."

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. In the game of investing, the financial croupiers always win, and investors as a group lose. After the deduction of the costs of investing, beating the stock market is a loser's game.

Less to Wall Street croupiers means more to Main Street investors.

Successful investing, then, is about minimizing the share of the returns earned by our corporations that is consumed by Wall Street, and maximizing the share of returns that is delivered to Main Street. (That's *you*, dear reader.)

Your chances of earning your fair share of the market's returns are greatly enhanced if you minimize your trading in stocks. One academic study showed that during the strong bull market of 1990–1996 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 annual market return of 17.9 percent during that bull market period, 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 market return.

Mutual fund investors, too, have inflated ideas of their own omniscience.

They pick funds based on the recent performance superiority—or even the long-term superiority—of a fund manager, and often hire advisers to help them achieve the same goal (Warren Buffett's "Helpers," described in the next chapter). But as I explain in Chapter 12, the advisers do it with even less success.

Oblivious of the toll taken by costs, too many fund investors willingly pay heavy sales loads and incur excessive fund fees and expenses, and are unknowingly subjected to the substantial but undisclosed transaction costs incurred by funds as a result of their hyperactive portfolio turnover. Fund investors are confident that they can consistently select superior fund managers. *They are wrong*.

Mutual 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 shares of *businesses*, and businesses as a group earn substantial returns on their capital, pay out dividends to their owners, and reinvest what's left for their future growth.

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 other firms. 3 But in the aggregate, businesses have grown

with the long-term growth of our vibrant economy. Since 1929, for example, our nation's gross domestic product (GDP) has grown at a nominal annual rate of 6.2 percent; annual pretax profits of our nation's corporations have grown at a rate of 6.3 percent. The correlation between the growth of GDP and the growth of corporate profits is 0.98. (1.0 is perfect.) I assume that this long-term relationship will prevail in the years ahead.

Get out of the casino and stay out!

This book intends to show you why you should stop contributing to the croupiers of the financial markets. Why? Because during the past decade they have raked in something like \$565 billion each year from you and your fellow investors. It will also tell you how easy it is to avoid those croupiers: Simply buy a Standard & Poor's 500 Index fund or a total stock market index fund. 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 traditional index fund does.

Simple but not easy.

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, and 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 index revolution and invest in a new, "more economical, more efficient, even more honest way," 4 a more

productive way that will put your own interests first.

Thomas Paine and Common Sense.

It may seem farfetched for me to hope that any single 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 and scorn, even fear. Indeed, 240 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. . . . I offer nothing more than simple facts, plain arguments, and common sense.

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 responsibilities of our government and our citizens, the very fabric of our society.

Similarly, I believe that in the coming era, my own simple facts, plain arguments, and common sense will carry the day for investors. The Index Revolution will help us build a new and more efficient investment system for our nation, a system in which serving investors is its highest priority.

Structure and strategy.

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. It doesn't earn me a penny. Rather, I want to persuade you because those two rocks on which Vanguard was founded all those years ago—our truly mutual, fund-shareholder-owned structure and our index fund strategy

—will enrich *you* over the long term.

Don't take my word for it!

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 our wisest and most successful investors endorse the index fund concept; among academics, the acceptance is close to universal. *But don't take my word for it*. Listen to these independent experts who have no ax 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 the late Paul A. Samuelson, Nobel laureate in economic sciences and professor of economics at the Massachusetts Institute of Technology, to whose memory 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."

It will take a long time to fix our financial system. But the glacial pace of that change should not prevent you from looking after your own self-interest. You don't need to participate in its expensive foolishness. If you choose to play the winner's game of owning shares of businesses, and to 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 eliminating substantially all of its excessive costs.

Then, at last, you will be guaranteed to earn your fair share of 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. (Caution: You'll also earn your fair share of any interim negative returns.) When you understand these realities, you'll see that it's all about common sense.

The 10th Anniversary Edition of *The Little Book of Common Sense Investing*.

When the first edition of *The Little Book of Common Sense Investing* was published 10 years ago, my hope was that investors would find it useful in helping them to earn their fair share of whatever returns—positive or negative— our financial markets deliver.

That original *Little Book* of 2007 was a direct successor to my first book, *Bogle on Mutual Funds: New Perspectives for the Intelligent Investor*, published in 1994. Both books set forth the case for index investing, and both became the best-selling mutual fund books ever, with investors purchasing a combined total of more than 500,000 copies.

During the near quarter-century since the publication of my first book, index funds have come into their own. Assets of equity index funds have

risen 168-fold, from \$28 billion to \$4.6 trillion in mid-2017. In the past decade alone, U.S. investors have added \$2.1 trillion to their holdings of equity index funds and withdrawn more than \$900 billion from their holdings of actively managed equity funds. Such a huge \$3 trillion swing in investor preferences surely represents no less than an investment revolution.

In retrospect, it seems clear that my pioneering creation of the first index mutual fund in 1975 provided the spark that ignited the index revolution.

And it also seems reasonable to conclude that my books, read by an estimated 1.5 million readers, played a major role in fueling the extraordinary power of the revolution that followed.

The creative destruction reaped by index funds has, by and large, served investors well. As you read this 10th Anniversary Edition of The Little Book of Common Sense Investing, you'll see that it stands firmly behind the sound principles of its predecessors, with new chapters on dividends,

asset allocation, and retirement planning focused on the implementation of those principles.

Learn! Enjoy! Act!

JOHN C. BOGLE

Valley Forge, Pennsylvania

September 1, 2017

Don't Take My Word for It

Charles T. Munger, Warren Buffett's business 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