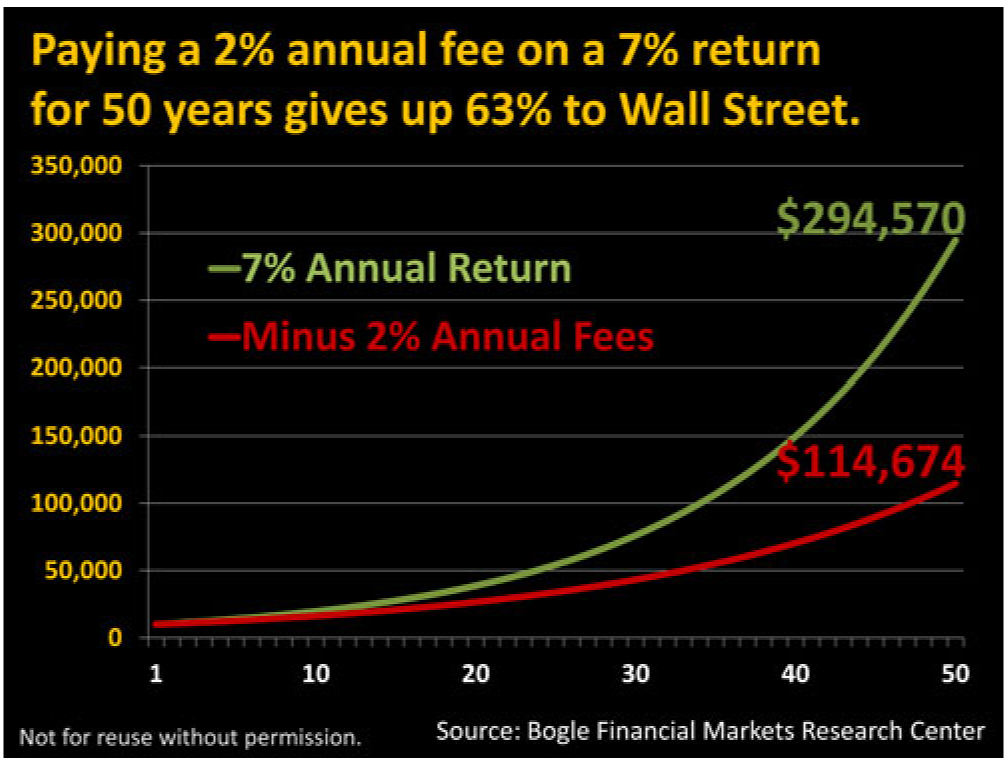
Expenses And Behavior Are Key To Investment Success

John Bogle, 84, is a hero to investors. His common sense message about controlling investment expenses helped him build The Vanguard Group into one of the world's largest mutual fund companies.

Bogle, for decades, has decried high fees extracted by Wall Street for managing mutual funds, and his message about the importance of low-expense investing is well-known. Nonetheless, the picture of retirement savings painted by Bogle in the PBS news-documentary series, *Frontline*, in March 2013, was astonishing. In a segment aptly titled, "The Retirement Gamble," Bogle shows that Americans, who save for retirement for their entire working lives in 401(k)s and IRAs, often wind up paying most of their nest eggs to Wall Street.

Using the accompanying chart, Bogle showed the ravaging effects of paying high fees on mutual funds. Paying 2% annually to a mutual fund that earns a return of 7% annually for 50 years, results in 63% of your nest egg going to pay Wall Street fees. Because of the magic of compounding, much of your retirement savings can go to paying mutual funds to manage your money.

Bogle shows why low-cost mutual funds can be crucial to retirement success. He criticizes the use of "actively managed" funds that try to pick the right stock or bond to hold in a portfolio in favors of the use of index funds and Exchange Traded Funds (ETFs), which offer much lower expenses.



Bogle and *Frontline* did a great service and low-expense investments are a no-brainer. Where it gets complicated, however, is in choosing the right allocations for low-expenses investments. Creating a mix of investments that is less likely to prompt you to sell a strategic holding after it has dropped sharply can be just as crucial to achieving retirement success as maintaining low expenses. In fact, research indicates that "behavioral finance" issues actually lower investor returns more than the use of high-expense investments.

In the 20 years that ended December 31, 2012, the average annual return of all investors in U.S. stock mutual funds was 4.25%, according to a study by Dalbar, a Boston-based financial research group. Over the same period, the benchmark Standard & Poor's 500-stock index returned an annualized gain of 8.21%. That's a huge gap—nearly four-percentage points every year for over two decades. To be clear, failing to make a long-term investment plan and stick to it caused fund investors to lose four percentage points a year—twice the drag of high-expense funds.

Why do fund investors fare so poorly? Because they tend to buy high and sell low. Dalbar and academic studies have shown repeatedly that investors become rattled when stock prices fall and they sell what intended to be long-term holdings. In a pattern that keeps repeating itself, investors historically, repeatedly overreacted to short-term emotional volatility. How do you avoid doing this?

There is no perfect answer because we're all subject to human foibles. In good or bad times, people have a natural tendency to extrapolate recent events into the future. People forget that, in the past, better times have always returned after bad times. While there is never a guarantee that good times will return after every downturn, betting on a rebound was statistically and historically always the right choice in the past. To fight the human predilection for selling when a market is bottoming, three pillars seem crucial to support your effort.

1. An investment policy statement written in unemotional times that commits you to holding on through downturns and that is in tune with your risk profile and how much money you need to fund your goals in life.
2. Spreading investments across a range of markets that are not highly correlated with one another to try to dampen the effects of the next investment downturn and make you less-susceptible to reacting emotionally in bad financial times.
3. A relationship with a financial professional who tracks markets daily but understands their history and who can help you stick with your long-term strategy even in tough times.

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