Is ‘stay the course’ still valid?

After 25 years at Vanguard, Chief Investment Officer Gus Sauter is retiring at the end of 2012. In a recent interview, he and his successor, Tim Buckley, shared their perspectives on sovereign-debt headaches, ongoing market volatility, and prevailing uncertainty.

Earlier this year, Vanguard announced that Mortimer J. (“Tim”) Buckley, managing director of Vanguard’s Retail Investor Group since 2006, will become the firm’s chief investment officer as of year-end 2012, succeeding current CIO George U. (“Gus”) Sauter, who plans to retire after 25 years at Vanguard. Mr. Buckley started with Vanguard in 1991 as assistant to the chairman, and has held a number of senior leadership positions over his 20-year tenure, including Vanguard’s chief information officer from 2001 to 2006. Vanguard Investment Perspectives talked with both Mr. Sauter and Mr. Buckley about the current market environment and how investors can maintain a long-term perspective.

What are the biggest worries facing investors?

Mr. Sauter: I think we’re facing two major macroeconomic events. One is the continuing U.S. fiscal crisis, including the so-called fiscal cliff that’s approaching at the end of 2012, if all the tax cuts expire and extensive budget cuts are implemented. And, second, I think the European debt crisis is something that’s going to be with us for many years to come.

On a more micro level, I think a lot of investors are still concerned about inflation. They look at the actions taken by the Federal Reserve, and they believe those will translate into inflation. But honestly, I don’t think inflation is imminent. The Federal Reserve’s actions have not resulted in a significant increase in the growth of the money supply, contrary to popular opinion.

I also think investors are worried about income. They’re getting very low returns when investing in money market and bond funds, so they’ve started to chase high-yielding equities. But that entails taking other risks that investors may or may not be aware of.

Mr. Buckley: Talking to business owners and talking to investors, the single biggest concern, if I could wrap it up into one thing, is uncertainty—not necessarily about what market returns will be,
but about the macroeconomic issues that Gus mentioned. Many investors wonder, “What will happen in Europe, and how does that affect me?” And here in the United States, there’s uncertainty about tax policy and who will pay the rising health care bill. All of these things keep businesses from investing in capital, and investing in jobs. And without that investment, it’s tough to see a nice recovery.

If these issues aren’t going to be resolved soon, what can investors do, if anything?

Mr. Sauter: I think investors should recognize that to a large extent these ongoing challenges are already priced into the market, so trying to adjust your investment strategy is probably too late. In fact, I think investors should not focus so intently on the current macroeconomic concerns, because there are always going to be macroeconomic concerns. They really should keep thinking longer-term. From Vanguard’s long-term perspective, we think equity markets are reasonably priced, with bond markets perhaps a little less so because of lower current interest rates. We think the global stock markets should provide reasonable long-term returns going forward, even in a softer economic environment. So I absolutely think that “stay the course” is still appropriate advice. I think this notion about “go anywhere investing” is the triumph of hope over reason. Unfortunately, it’s a very hard thing to implement. And so, it’s important, really, just to stick with the proven principles of broad diversification, balance in a portfolio, and low costs. I think you need to tune out the noise, tune out all the macroeconomic events, and just think longer-term.

Mr. Buckley: We think the best thing you can do in the face of uncertainty is to stay diversified. If you look at the kind of balanced approach we’ve advocated through the years, it’s one that has actually worked. Ten-year average annual returns as of the end of September are fairly solid. We’ve got over 8.5% from the U.S. stock market, about 5.2% from the U.S. bond market, and about 7.6% for a 60/40 mix of stocks and bonds. It may not have felt like it, but in reality the 60/40 portfolio that returned almost 8% per year over the past ten years was significantly less volatile than a portfolio invested 100% in stocks.

Now some investors might say, “Well, should we change that going forward? Bonds can’t return what they have in the past.” It’s true that bond yields are at historical lows. But we don’t say hold bonds because we think they’re going to outperform stocks. We say include bonds in a portfolio because they could play an important role in muting volatility, especially as investors look toward retirement, when they’ll need to spend from their portfolios. Stocks are what will provide most of your long-term growth.

With slower economic growth and low bond yields, should investors lower their expectations for future returns?

Mr. Sauter: Certainly with bonds, I think returns will be lower over the next decade than they have been historically. And that’s because of the current very low interest rate environment. The best predictor of bonds’ future long-term returns is the current yield to maturity. And with a yield to maturity of the 10-year note being less than 2%, it probably means we’ll have lower than historical rates of return from fixed income.

On the equity side though, I think the markets are trying to adjust for lower expected growth going forward. And, therefore, I think we can expect roughly historical rates of return over the next decade, at least on a real, or inflation-adjusted, basis. In other words, since I think inflation will remain under control over the next decade, we might have slightly lower nominal returns from equities than we’ve had historically, but the real returns should be somewhat in line with historical levels. And, again, that’s because the markets are trying to adjust for expectations for the future, and so they’ve already discounted a low-growth environment for the next five to ten years.
Mr. Buckley: Investors realize that there’s no free lunch out there, that to get returns you have to take risk, and with risk comes volatility. And that means that there will be some good years and some bad years. Our models would tell you to expect below-average returns from bonds and historical rates for stocks. That said, the standard deviations around these return estimates are wide, especially with stocks—so stay diversified!

In the search for returns, should investors consider investing more aggressively outside the United States?

Mr. Sauter: Investors who expect higher returns from investing internationally, particularly in emerging markets, may be disappointed going forward. While we expect emerging market economies to grow at a higher rate than developed market economies, there’s never been any correlation between economic growth and equity returns. So investors may be disappointed if they overweight their portfolio in emerging markets.

The main benefit from investing internationally is the increased diversification. I think investors have increased their holdings of international securities over the last 10 or 15 years, but probably, on average, they’re still a little bit light in foreign securities. At the same time, while it’s important to get broader diversification by having a meaningful allocation to international securities, I think it is also appropriate to have a home country bias. In other words, you can think of many investment problems as trying to meet your future liabilities. So, for most U.S. investors, a large portion of their future liabilities will be spent in the United States. And, therefore, you should probably have an overweight to U.S. securities relative to their weight in a global basket.

[Editor’s note: For more on this topic, see the research paper The Role of Home Bias in Global Asset Allocation Decisions by Philips, Kinniry, and Donaldson, 2012, at vanguard.com/research.]

Is the rise of ETFs a good thing, and will they continue to gain assets?

Mr. Sauter: I think a lot of people don’t fully understand what ETFs are. I’ve heard the comment many times that ETFs are a great new product. Well, in fact, ETFs are a new way to distribute an old product. I think ETFs represent a new distribution strategy, and to the extent that investors might prefer that way to invest in an index fund, I think ETFs provide a nice choice.

I expect ETF assets and cash flows will continue to increase, and that’s because more and more people are learning about them. I don’t think they’ve reached any degree of saturation. It’s largely been a great way for financial advisors and other intermediaries to invest for their clients. And still, I think we’re scratching the surface on that. I think ETFs will grow exponentially in the foreseeable future.

Mr. Buckley: ETFs have certainly extended the reach of indexing. When I joined this business in 1991, indexing represented about 2% of assets, and today I believe it’s well over 20%. The first ten years of that growth came from traditional mutual funds, but in the last ten years it’s really been driven by ETF growth, an adoption of indexing by a new set of clients. It used to be institutions, retirement plans, and direct investors that did a lot of indexing. Now you see advisors embracing indexing on behalf of their clients—ETFs fit better on their platforms. While there are minor differences between traditional mutual funds and ETFs in terms of liquidity and some other nuances, for the most part they both seek to offer the market return, low turnover, and low costs—the keys to long-term investing success.
What other trends are worth watching in the investment business?

Mr. Sauter: We already discussed ETFs, but I think indexing in general can continue to grow in popularity. The beauty of that is that indexing just gets better with size. It’s actually easier to manage a large index fund than a small index fund. So here at Vanguard we can continue to grow that side of our business indefinitely.

I would note, though, that the argument for indexing does not rule out that some investors can outperform the market. The biggest disadvantage that active investors have is cost. Vanguard also holds that low-cost active management, when prudently applied, may have a chance of actually outperforming the market. And so, we look for the best managers in the world. And we always ensure that they’re going to manage our investors’ assets for low fees and, therefore, hopefultly, maximize the opportunity for our active funds to outperform the market. There are, of course, uncertainties, and some of our funds might underperform. But we believe that active management, when well applied in a low-cost fashion, may be a good complement to a foundation built around index investments.

Mr. Buckley: Watch the continued growth of simple options for clients. One of the best things to happen in the defined contribution world has been automatic enrollment combined with target-date funds. Many young investors have not been taking enough risk. But if they’ve been auto-enrolled in a retirement plan and put into a target-date fund, then they’re taking the risk appropriate for a long-term investor. They’re automatically invested in equities, and we still believe, over the long run, that equities will give you the growth you need to build a retirement portfolio. I believe auto-enrollment in target-date funds has been just a great step forward in the 401(k) world.

How are you handling the transition of CIO duties, and what changes might we expect?

Mr. Sauter: We intentionally wanted to have an extended six-month transition to make sure everything would go smoothly. Tim and I have been working together now for several months, and some of my former direct reports are already reporting to him. We’ve visited Vanguard’s various sites around the country, and we recently went to our Melbourne (Australia) office together.

Mr. Buckley: We’ll continue to strive to offer funds that are world-class, those that we believe fit our investment philosophy. From an operational standpoint, we expect to continue to expand our global presence. It’s something that Gus started. We’ll manage money the same way regardless of where our footprint is, but now we’ll be able to bring in talent from around the globe, and we’ll be able to deliver the Vanguard approach to a broader range of clients.

Of course, the core of how we invest, and what we care about, will remain the same. It’s been that way since Vanguard started—putting clients first, keeping cost low, and seeking to outperform over the long term.

Note on risk: Investments in target-date funds are subject to the risks of their underlying funds. The year in the fund name refers to the approximate year (the target date) when an investor in the fund would retire and leave the workforce. The fund will gradually shift its emphasis from more aggressive investments to more conservative ones based on its target date. An investment in a target-date fund is not guaranteed at any time, including on or after the target date.
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