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John Bogle on How to Build a Winning Mutual Fund Portfolio

July 2017

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This eBook intends to educate and inform investors. Any fund names or other content in this eBook should not be taken as investment advice. It is recommended that you consult an investment adviser to discuss your financial goals and build your own portfolio.

Who is John Bogle?

Back in 1975, the world's first index mutual fund was started with the guiding principle of "trusteeship". It put the investor first and ensured that the maximum share of the investment rewards went to the investor.

The fund house, a familiar name now, is Vanguard. As of today, Vanguard is the largest no-load mutual fund house in the world managing over USD 3.5 trillion for its unit holders. To understand this better perspective, the size of the economy of India is USD 2 trillion.

Well, the man who is responsible for creating and building Vanguard is its founder John C. Bogle.

John Bogle started studying mutual in 1949 when he began his senior thesis at Princeton University. His thesis was about how it is impossible for individuals to beat the markets over a long period of time. He joined the industry in 1951. In 1975, he launched Vanguard.

Bogle has been named as one of America's four financial "**giants of the twentieth century**" by Fortune magazine.

He has been very vocal about how Wall Street works to the disadvantage of investors. It creates complex and expensive which act as a poison in investor's portfolios.

Warren Buffett, in his recent letter to shareholders, wrote:

> *"If a statue is ever erected to honor the person who has done the most for American investors, the hands- down choice should be Jack Bogle."*

Bogle is a hard-core believer in indexing or buying index funds. In his findings, a broad market index fund will almost always beat an actively managed fund. This will primarily be a function of the costs that are loaded onto actively managed funds. He outlines his approach very logically in his book Common Sense on Mutual Funds.

However, not everyone wants or believes in index funds. In countries such as India, the actively managed funds have done far better and have quite a bit of runway left before the passive style becomes dominant.

For those who would still go the other way and choose actively managed funds, Bogle has shared **8 rules to build a mutual fund portfolio**.

The rules have been explained in great detail in his book Common Sense on Mutual Funds. In this eBook, we bring to you the essence of these 8 rules.

You should note something important here. Bogle wrote these rules in the context of US market. However, any sensible investor can use these rules to build a mutual fund portfolio that is geared to meet long-term financial goals.

For investors in active funds too, the rules are a must know. You can platinum-proof your portfolio by applying these simple 8 rules. And as Bogle says, it is common sense on mutual funds.

Read on.

Rule #1

Select Low Cost Funds

When it comes to costs, Bogle is considered a “fringe fanatic”. He simply says “Costs matter”. So much so, that out of this 8 rules he has made this **Rule No. 1**.

He writes, “A low expense ratio is the single most important reason a fund does well.” And so “if you select actively managed funds, emulate the index advantage by choosing low-cost funds.”

A better way to understand would be this. Every thing else remaining the same including the market conditions and investment skills, what will differentiate the performance of one fund from another is the cost or expenses?

Haven’t we seen the impact of cost across businesses? Airlines, Hotels, E-commerce, you name it. The one with a lower cost enjoys some distinct advantages.

You don’t have to go too far. We now have the direct plans of mutual funds, which deliver a higher return compared to their regular counterparts. The difference between the two again is primarily because of costs – costs of commissions paid out to distributors.

But as the savings in expenses compound over the years, the difference in returns between the two plans could be as much as 50% or more of the original investment amount.

Talk about costs!

Rule #2

Consider Carefully the Added Costs of Advice

This is yet another aspect of cost that investors need to consider. As investors, we sometimes rely on advisors to help us make the right investment decisions and choose the funds that will help us meet our financial goals.

Bogle points out that you have to carefully consider the cost of the advice that you take. After all, this cost that can impact your returns too.

"You should know exactly how much an adviser's services cost. Advice may be provided by registered "fee-only" investment advisers…" writes Bogle.

A good approach would be to take advice from a fee-only registered investment adviser and then invest in direct plans of mutual funds. This way you separate the two costs of advice and fund management and get better control on what you pay for advice.

Rule #3

Do not overrate past fund performance

"...the first element that catches the eye of most investors, whether experienced or novice: the funds's past track record." Bogle nails it with this one statement.

Past performance does indeed catch the fancy of every single investor including you and me. This famous line from an auto company advertisement sums it all "*kitna degi*".

He goes on to add, "(*past track record is*) usually hopelessly misleading in appraising how a money manager will perform. There is no way under the sun to forecast a fund's future absolute returns based on its past record."

However, what can be forecast with relatively higher success is that the funds with consistently high expense ratios will tend to underperform peers in their category.

Yet another certainty would be that the funds that have delivered super high returns and have been category toppers in the past will revert to the mean or move towards average performance.

Reversion to the mean is a simple law, which means that the funds that are up will come down and those that are down will go up.

The two funds that had been the talk of the town for the above reasons are HDFC Equity and HDFC Top 200. Several sectoral and thematic funds also follow the same pattern, more visibly though.

Now you got to note this. Unfortunately, the fund houses almost

always promote the best performing funds to you. Why?

This is because as an investor, you are influenced by past returns. That is not healthy. You must understand and not give too much weightage to the past returns.

Read on.

Further Read: How not to select mutual funds

Rule #4

Use past performance to determine consistency and risk

Now, past performance has some use.

"The intelligent investor" can use the past performance to determine consistency of performance and to know the risk that the fund took to achieve that performance.

Bogle says, "look for consistency – it is a virtue of a mutual fund."

How do you look for consistency?
It is simple. The fund should have been in the top quartile of performance for a major part of its existence. Yes, there can be periods, when it does not perform well. You need not hold that too much against it.

The quartile performance information is available on portals such as Morningstar.

While you look at numbers, compare apples to apples, that is, compare funds with similar policies and objectives. So a large cap value fund should be compared with another large cap value fund, a mid cap growth fund with another mid cap growth fund and so on and so forth.

For example, Franklin India Bluechip and Birla Sun Life Frontline Equity are comparable large cap funds.

The next element is risk.

"Markets, no matter what you may have come to think, do not *always* rise! Risk should be given the most careful consideration by the intelligent investor", warns Bogle.

What you basically need to look at is how much additional risk did the fund take vis-à-vis say a safe investment such as a Government Treasury Bill, to generate additional returns. Technically, this measurement is known as a **Sharpe Ratio**. Again, this information is widely available on various financial portals as well as fund factsheets.

Between 2 funds, which generated similar returns but one took a higher risk, that too on an ongoing basis, should be avoided.

Rule #5

Beware of Stars

Here Bogle refers to the "**star fund managers**".

The problem, as pointed out by Bogle, with star managers is two-fold.

One, no one can tell in advance who the star is going to be.
Two, star managers never stay in the same organisation with the exception of a few.

This is how Bogle describes the "Stars".

"These superstars are like comets; they brighten the firmament for a moment in time, only to burn out and vanish into dark universe. Seek good fund managers if you will, but rely on their professionalism, experience, and steadfastness rather than their stardom."

In India, we have the likes of Prashant Jain, Nilesh Shah, Kenneth Andrade, Anoop Bhaskar – considered stars in their own way.

Nilesh Shah, now with Kotak, has gone through his switches from organisations such as Axis and ICICI. Kenneth Andrade, a star fund manager, left IDFC recently. Anoop Bhaskar moved on from Sundaram Mutual to UTI Mutual Fund and is now with IDFC Mutual Fund.

As a star fund manager moves on, a new one takes his place and thus begins the process of portfolio overhaul to suit the preferences of the new manager. This could lead to high turnover and added costs.

Rule #6

Beware of Asset Size

Bogle has 2 very simple things to say on this.

“Avoid large fund organisations that:

- have no history of closing funds, that is, terminating the offering of their shares-to new investors, or
- seem willing to let their funds grow, irrespective of their investment goals, to seemingly infinite size, beyond their power to differentiate their investment results from the crowd.”

“Funds can get too big... ". How much is "too big", is a complex issue. It has to be determined with respect to fund style, management philosophy, and portfolio strategy.

A large cap fund can be managed even with Rs. 50,000 crores of AUM size. But a small cap fund of that size is bound to fail because there will not be enough investment opportunities to seek out.

Ideally, in that case the fund should stop taking any further investor money and even refund the monies if it cannot manage it.

Unfortunately, in India, such instances where funds have closed new subscriptions or returned investor money are rare.

SBI Small and Mid Cap fund stopped taking fresh SIPs in its fund from Oct 30, 2015. The fund had in advance defined a size constraint of Rs. 750 crores. As soon as it started to reach that size, fresh subscriptions were stopped.

In February 2017, DSP Blackrock Micro Cap Fund too stopped

taking fresh subscriptions in the fund.

But as I mentioned, these are rare cases. The greed of building large AUMs and earn more fees has deep roots in the mutual fund industry. In fact, some funds even change their avatars to accommodate rising investor interest.

ICICI Pru Value Discovery Fund did that. The fund started as a midcap fund and delivered stellar performance. As the asset size grew, the fund knew that it would find it difficult to get enough opportunities in the mid cap space alone.

But it had to accommodate the growing investor interest, who, as usual, were looking at past performance to include this fund in their portfolio. Hence, it changed itself into a multicap/ flexicap fund with a brand new benchmark, Nifty 500. The fund now has the entire market available for it to seek opportunities and invest in.

Remember though that it is no more a focused midcap fund. Of course, the investors still continue to pour money. It remains to be seen if the fund will continue to deliver as stellar a performance as before.

Rule #7

Don't own too many funds

"I truly believe that it is generally unnecessary to go much beyond four or five equity funds" is the sage advice from Bogle. I am sure you have heard that before too.

Any more funds neither help you reduce risk substantially nor deliver superior performance. In fact, the more funds you add could potentially lead to under performance or average performance. Your money spreads thin across several funds and any one fund fails to make a substantial impact on the portfolio.

Bogle says that you could as well hold an index fund with far lesser risk and costs and save yourself the hassle of managing a big portfolio.

The simple rule is: each fund that you add to your portfolio should have a **significant** impact in diversifying the portfolio.

Here's what an equity mutual fund portfolio geared for over 10 years of time horizon with a reasonably high risk tolerance can include:

- Flexi Cap - 1
- Flexi Cap - 2
- Mid Cap
- Small / Micro Cap

I would give 25% to each of the funds. This would result in diversifying across market caps and investing styles thus covering all possible investment opportunities.

However, that's not the rule. You can have 2 or 3 funds too in your

mutual fund portfolio. The allocations could be different as well. You should know what your fund is doing for you and not add anything blindly.

Keep it lean.

Rule #8

Buy your fund portfolio – and hold it

Let’s understand one thing – **mutual funds are not stocks**. There is no need to buy and sell funds based on performance variations, look at target prices and book profits at "some target levels". This is not a video game.

So what do you do?

Bogle's advice is, “When you have identified your long-term objectives, defined your tolerance for risk, and carefully selected....funds that meet your goals, stay the course. Hold tight.”

The key to holding tight is buying right. Buying right is about avoiding some fundamental errors as listed earlier in the previous rules.

Post that, **you need to monitor your funds no more than once in a year.**

So, when do dump your fund?

Unless the fund shows the following characteristics, there is NO need to do anything.

- Extended period of non-performance,
- A radical shift in its investment objective or policy or
- An upward change in fee structure

Even if you have to change your view based on the events, thoroughly investigate and then take action.

Bogle further says, “Select a fund with the same thoughtful consideration you would give to appointing a trustee for your assets and establishing a lifetime relationship.”

Let me repeat - **a lifetime relationship.** That does not seem to be the norm these days but something we can always strive for.

So, these are the 8 simple rules as laid out by John Bogle to build a winning mutual fund portfolio.

Now, it will be important to note that you have to use the 8 rules together and not rely on just one of them.

PERSONALISED ADVISORY SERVICES

Do you feel that you approach towards your money is not structured?

Do you feel constrained for time or effort to make the right investment decisions?

Do you feel you have not been getting the right advice and you cannot trust your agent/advisor?

Do you feel you can do better with your money and investments?

Do not ignore these feelings.

You see, by itself, money has no meaning unless it helps you achieve your goals and enables a fulfilled and meaningful life.

Here is a comprehensive exercise where we develop a plan to channelise your money in the best possible way. The service also includes a review of any existing investments that you might have.

When you work with an advisor to ensure that your portfolio is in alignment with your values and your goals.

To know more about Personalised Advisory Service and have a preliminary discussion, please write to me at vipin[at]unovest[dot]co along with the necessary details and he will get in touch with you.

Regards,

Vipin