

Smart Investing 2006

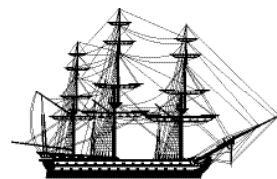
TIME-TESTED WAYS TO INVEST TODAY

Why traders are playing
a loser's game

What super's
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signs are pointing
for the year ahead

8 top investment reads



Vanguard INVESTMENTS™

Traders playing a loser's game

Buy and hold investors are disappearing and being replaced by those with short-term investment horizons. But new research shows that the more investors trade the lower their returns. By Susan Hely

My father has always bought shares and kept meticulous records of their price movements with hand drawn graphs. He now gets instant updates of prices, dividends and company announcements on his computer. Technology also allows him to trade easily and instead of holding onto shares like he once did, he is what I call a day trader. It is not uncommon for him to buy a share in the morning and sell it by the close of trading.

He is not alone. Instead of keeping an investment for around five years or longer, Australians are increasingly buying and selling their shares and managed funds over the short term. In the 1960s investors turned over their shares 17 per cent each year and this means that their entire share portfolio was traded over five years. From 1990 to 2005 the level of turnover increased five times. The average turnover for shares in Australia is 100 per cent each year, compared to 125 per cent in the United States. This means the average Australian investor turns over their shares every year while Americans sell their shares every nine months according to

research by Vanguard Investments. An Australian investor with \$50,000 in shares will be selling and buying \$1000 worth of shares every week.

The switch from long-term to short-term investing is a sea change in investing. Does this mean that long-term investing is a worthy concept that no longer applies in the modern investment world?

Research by American academics Brad Barber and Terrance Odean from the graduate school of management at the University of California examines the returns from active share traders to see if short-term investing reaps benefits for investors. They combed through 67,000 accounts with discount brokers in the US from 1991 to 1996 and found that the average household that turned over their shares 75 per cent for the year had an annual return of 16.4 per cent, which was 1.5 per cent below the market gain of 17.9 per cent. But the individual investors who traded more frequently turning over their shares by 250 per cent each year over six years underperformed the market returns by 6.5 per cent on average each year. The active investors who preferred small value shares that carried a higher level of risk than large company shares only earned 11.4 per cent per annum from their busy trading.

Barber and Odean found that investors who trade actively are hit by high costs of buying and selling that in the short term appear immaterial but over the long term can be profound. They concluded that active traders do not behave rationally but typically suffer from overconfidence in their stock picking abilities and this leads to too much share trading. "Our central message is that trading is hazardous to your wealth."

They make the point that investors' active investment strategies don't outperform a passive investment in a diversified index fund but still they prefer to actively trade. "Overconfident investors will overestimate the value of their private information, causing them to trade too actively and consequently earn below average returns," say the researchers, Barber and Odean.

Behavioral finance studies show that active traders tend to buy into companies with recent good performance and refrain from selling any companies with share prices going backwards. The psychologists find that people tend to give themselves too much credit for their success rather than putting it down to chance or outside circumstances. On a large scale, the overconfident investors can lead to a precipitous bull market.



The research confirms what a number of investment experts have been saying for some time. Charles Ellis, a pre-eminent US investment consultant, says in his book, *How To Win the Loser's Game*, now a classic investment textbook, that investors who wake up every day wondering where are today's opportunities don't appreciate that investing is a loser's game.

Who are the biggest losers? Men, according to Barber and Odean who found that men are more active share traders than women. According to one of their other studies, this time with 35,000 investors in the US, men trade 45 per cent more than women and as a result their investments perform much worse than women's investments. The higher trading reduces men's net returns by 2.65 per cent a year as opposed to 1.72 per cent for women. Single men trade even more and lose more where single women do not trade as much as women with partners.

Ellis likens investing to social tennis. In social tennis the least adventurous, most consistent player usually wins, and the aggressive "wannabe" tennis star ultimately defeats himself with shots beyond his ability. The aggressive player loses the game by hitting

"Overconfident investors will overestimate the value of their private information, causing them to trade too actively and consequently earn below average returns."

too many balls into the net or out, compared to the conservative player. And so it is with investing. Trying too hard, being too adventurous, and trading too frequently is prone to too many costly mistakes. He says that sharemarkets are efficient and difficult to outsmart because of the combined intelligence and knowledge of those who work in the markets and make decisions. It's not so much a challenge of beating the market, it's more about not beating yourself, Ellis explains.

The Ellis solution is to emphasise long-term investment policy. By this he means what your typical asset allocation is across the major asset classes, based most critically on your risk tolerance and investment objectives. For example, should you have 20 per cent in growth assets or 80 per cent? This is far more important than worrying about which shares, or which managed funds or whether to be in or out of the market.

Ducking in and out of the market can have very high opportunity costs. One strategy is to implement an investment policy through low-cost index funds, including exchange traded funds, and worry about very little on a day-to-day basis. To use the Ellis analogy, this avoids ever hitting the ball out or into the net. 🎾

Watch your costs

Jack Bogle, founder of Vanguard and retired chairman, says that corporate greed and short-term speculative investment strategies in the United States have cost investors strong returns and estimates that low returns will continue in the US for the coming decade.

Bogle was recently speaking at the Association of Superannuation Funds of Australia's annual conference about his latest book, *The Battle for the Soul of Capitalism*. He explains how corporate managers in the US put their own interests ahead of investors and nearly derailed the American financial system. He believes that the return on a portfolio that is made up of 75 per cent in equities and 25 per cent in bonds will be around 7 per cent before fees from 2005 to 2015. This is half the 14 per cent return over 1980 to 2005.

Yields from US bonds will be 4.75 per cent per annum, over 2005-2015 compared to the strong gains of 11.5 per cent from 1980 to 2005.

What can you do about the low returns? Rather than panic and chase returns, one important strategy is to watch your costs. When returns are high, large fees and transaction costs don't show up as much as when performance is single digit.

Bogle says fees, including operating costs, portfolio fees and commission to financial planners can take 1.5 per cent to 4 per cent from your investment gain. If it is the lower end of fees, then it is still only a real return of 5.5 per cent or around 3 per cent after inflation.

Bogle says keep your investment expenses under control and the low costs make the investment game much easier and rewarding.

Bogle also emphasises it is important to stick to simplicity with your investments and not to complicate the investment process. Also remember that impulse is your enemy and it is best to eliminate emotion from your investment program.

He explains that it is important to have rational expectations about the future returns on your investments. When the investment climate changes, it is best to avoid switching those expectations.

Bogle has told investors repeatedly to "stay the course" over the years. No matter what happens, stick to your investment program. It has become his most famous investment wisdom.

Economic signs for the year ahead

What will the New Year bring for investors? Dr David Clark* makes the case for a satisfactory outcome.

Will the year ahead be another good one for the global and Australian economies and a reasonable one for most investors? Although all economic forecasting is much more an art than a science, the consensus is a qualified “yes” to both questions. Certainly, the global economy has few storm clouds on its horizon.

Continuing solid economic growth is forecast for the United States, a sustained recovery is expected for Japan, China is expected to keep powering along, and a pick-up in economic activity is expected in the euro area. The big worry in the US is that inflation will pick up more than expected, owing to the lagged effects of higher energy prices.

However, further likely falls in energy prices are expected to see US inflation return to late 2005 levels in 2007, preventing the need for the US Federal Reserve to push interest rates up to a level which would seriously slow the US economy. Lower oil prices are also likely to produce a pickup in US consumer spending, putting a floor under US manufacturing and world commodity prices. All of the above looks promising for Australia. Indeed, the OECD forecasts Australia’s real GDP growth rate to pick up to 3.2 per cent in 2006 and to 3.6 per cent in 2007.

Continued strength in business investment and solid growth in resource, mineral and agricultural exports are expected to be the major contributors to this good growth outlook.

A most welcome growth in exports will also help reduce our current account deficit, currently running at nearly 6 per cent of GDP. Indeed, the OECD expects that it will fall to 5.2 per cent of GDP in 2007.

Company earnings also should remain solid, putting an important floor under our sharemarket. However, optimistic outlooks like this should always be accompanied by a close consideration of the major factors which may leave the forecasters with egg all over their keyboards and computer models.

Five main risks to the above optimistic scenario stand out. A danger foreseen is half avoided. The first is a renewed surge in oil prices. This looks unlikely but prices will not fall dramatically, given the continuing growth in demand from China, refinery capacity limitations, and the fact that oil production takes considerable time to increase in response to price rises.

The second risk is ever-worsening fiscal and current account imbalances which could produce sharp exchange rate re-alignments. The biggest worry here is the huge US Budget and current account deficits. But the optimists argue that they will now at least level off,

preventing a sharp \$US fall, and subsequent currency market destabilisations across the globe.

The third risk is worse than expected US and global inflation, which would push up interest rates and slow US and global growth. Australia would then likely suffer both lower export growth and higher interest rates. But the new Federal Reserve head is expected to keep the lid on US inflation.

The fourth risk is a sharp, sustained fall on Wall Street. Unfortunately, the timing of the big sharemarket corrections is never predicted. But the sharemarket fundamentals in the US and Australia are not pointing to a dramatic, sustained correction over 2006. Company earnings look solid and US price/earnings ratios are way below the dangerous levels they reached in the late 1990s. Only a totally unforeseeable event – or “X factor” – could produce a global sharemarket correction. Australian equities should thus have a reasonable year.

However, strong GDP growth does not guarantee that share markets will not fall sharply. What happened in 2002 is a good recent example. Although Australia had only a tiny “new economy” and our IT shares had not gone on the wild ride they did in the US, the US correction sent tsunamis through our small “new economy” market.

The fifth and final, possible risk factor is a collapse in housing prices in the US and/or other major economies. In advanced economies consumer spending is usually responsible for more than two-thirds of economic growth. Further falls in house prices would thus cut consumer spending and economic growth in countries such as the US and Australia.

A just-released OECD study found that between the first quarter of 1996 and the first quarter of 2004 Australian real house prices climbed 85 per cent. A correction was thus inevitable. But so far the correction has been orderly, despite some predictions.

Since the early 1970s, downturns in the Australian house market have averaged around 10 quarters, or 30 months, with an average price fall of 10.1 per cent. Thus, if history repeats itself, we are unlikely to see a sharp rise in house prices over the year ahead, despite our reasonable interest rates, our low unemployment rate and high immigration intake – or a sharp collapse in prices.

What does all the above mean for Australian interest rates and the \$A? One of the few organisations which dare to forecast Australian short-term rates is the OECD. It is predicting only a 0.25 percentage point rise in the average rate over the next two years, compared with the 2005 level. Only a sharp and



Index funds: how to get on board

How to find your way around Vanguard

sustained rise in wage inflation is likely to change this picture.

The little “Aussie battler” – the \$A – will remain impossible to predict accurately, because it is influenced by a number of different factors, whose relative importance can change from day to day. For example, at times it tracks the prices we receive for key exports such as copper, gold and alumina. But it can also be seriously affected by the differential between our interest rates and those in bigger economies, notably the US.

When that differential increases it can encourage foreigners to park money in Australia, which in turn increases the demand for the \$A and its relative value. A decrease in the differential has a converse effect.

Exchange rates are also a double-headed coin. For example, to pick the \$A/\$US exchange rate one not only has to predict developments at home but in the US and the currencies of both countries do not simply follow changes in their “fundamentals”. However, the consensus for the \$A is that it will probably trade in the US72-78 cents range over 2006.

In short, economic forecasters have far from 20:20 vision but the outlook for the global and Australian economies over the year ahead generally looks good for investors’ hip pockets and purses. #

*Dr David Clark teaches Business Economics at the University of NSW and is a contributor to Asset magazine. The views expressed are Dr Clark’s, not necessarily Vanguard’s.

2006 economic outlook in a nutshell

International

Global economy	Solid growth ahead
Asian economies	Will remain strong
US economy	Growth to continue
\$US	Will remain volatile
\$US inflation	Under control
Oil price	Further fall likely

Australia

Trading partners’ growth	Good, esp. China
GDP	Higher over 2006-07
Commodity prices	Sharp fall unlikely
\$A	Likely range US72-78 cents
Inflation	Under control
Short-term rates	Little change likely
Bond yields	Little change likely
Business investment	Will slow a little
Consumer spending	Collapse unlikely
Company earnings	Will remain solid
Equities	Sustained fall unlikely
Bonds	Below return on equities

Vanguard’s index funds – how to invest?

If you are looking for excellent diversification, long-term performance and low costs, Vanguard has a range of asset sector and diversified index funds. You can build your own portfolio using any combination of the asset sector funds, or select from our range of pre-mixed diversified index funds.

Vanguard’s Investor Funds

Vanguard’s Investor Funds are offered to you at a much lower cost than most other actively managed retail funds. Our fees range from 0.70% to 0.90% p.a. (for the minimum investment) depending on the fund selected. There are also discounts for those investing more than \$50,000, reducing costs even further. For balances over \$100,000 our maximum fee is 0.45% p.a. You can start with an initial investment of \$5000 in any of our funds.

Vanguard’s Personal Superannuation Plan

Vanguard’s Personal Superannuation Plan is an accumulation super fund which accepts all types of contributions, including compulsory employer contributions. The Plan offers a diverse range of investment options through index funds. If you have multiple super accounts, Vanguard can arrange for your benefits in other superannuation funds to be transferred and consolidated in the Vanguard Personal Superannuation Plan. You can start a personal super fund with an initial investment of \$20,000.

Investor educational material

Vanguard is committed to helping people become better investors by offering a full range of educational materials available from our website or in printed form. These include:

Plain Talk guides

We have developed a range of 12 education guides on a variety of investment topics. Guides include: *Understanding indexing*, *DIY super* and *Understanding managed fund costs*.

Investing tools

Vanguard has developed several online calculators which are available at www.vanguard.com.au.

eVanguard

By subscribing to eVanguard you can receive the latest investment updates via email, Robin Bowerman’s *Smart Investing* weekly column and our quarterly *Helm* newsletter.

More information?

Speak to your financial adviser or order a copy of our Investor Funds or Personal Superannuation Plan Product Disclosure Statement at www.vanguard.com.au or call Client Services on 1300 655 101. #

Time-tested ways to invest

Common sense investment. Plain talk. Simple, cost-effective methods are some of the guiding lights for Vanguard's Jeremy Duffield. After 25 years in the business, he shares his deep market insights.

When Jeremy Duffield joined Vanguard more than 25 years ago he knew it was a small company with about \$US2 billion in assets under management. What he didn't know then was how the concept of indexing that was being promoted by Vanguard's founder, Jack Bogle, would change the way people and institutions viewed investment. Diversified portfolios with long-term investment horizons and low costs would prove a winning combination.

Duffield, who is managing director of Vanguard Investments Australia, spent 16 fruitful years working in Vanguard's senior management in the US before returning to Australia in the mid-1990s to establish its first office outside America. Like its US parent, its pickings were relatively small in the early days; indexing was not well understood, especially among the general investing public.

Today, Vanguard Investments Australia has \$A34 billion under management, of which \$4 billion has been entrusted to Vanguard from retail investors (\$800 million of which is invested directly).

Duffield is confident that this kind of exponential growth can only continue, especially as indexing gains wider acceptance among financial planners and their clients. He says: "We think the basic principles of investing are straightforward and can be mastered by most investors. People shouldn't be afraid to invest because they can get good information and good advice. We find financial advisers increasingly understand index funds, and as a consequence promote them because of low costs, predictability and the after-tax situation. In addition, choice of superannuation fund is creating more awareness about investment. Consumers are aware it pays to shop around. Once you get a decent amount of money in your super fund it becomes your biggest asset after your house; that gets your attention."

For the Melbourne-born Duffield, it has been an eventful journey, both in the US and back on his home turf. And he has never stopped learning. In this interview he shares the knowledge he has gained over the past 25 years, highlighting what he believes are some golden rules for investors, with particular reference to indexing.

Think long term: tomorrow's not too far away

The investment markets give and they take away, and you never know when they are going to give and when they are going to take away. Forget the short-term hills and valleys and think long term. This is rule number one.

Asset allocation: it's your choice

It's the most important decision individual investors make. Some investors forget to balance their portfolios and financial markets can change dramatically overnight; for example, some people only have shares, not allowing that a major correction may be just around the corner. Alternatively, some people are just too conser-

vative. They can be 25 and saving for retirement yet have all their money in cash. They think shares are too risky when, in fact, what's risky is holding a cash investment for a 25-year period when you have to protect yourself against inflation and pay taxes. Ultimately, asset allocation is about individual choice; you have to get the right balance of risk and return that suits you.

Diversification: spreading the risks

It typically means getting exposure to all asset classes – equities (domestic and overseas), property, fixed interest, cash and emerging markets. In equities, wide exposure is crucial. You can never be certain which industries will do well at any particular time. Look at how the local market has changed over the past 20 years; back then it was industrials and resources; today it's financial services which are 35% of the market. You also have to invest overseas because while the local economy is strong today, it won't always be so. And industries where we don't have a strong presence, such as IT and pharmaceuticals, might be going gang-busters.

Equities: foundation stone for long-term growth

Study investment markets and you realise equities have to be a key component of any long-term investment portfolio. It's reasonable to expect shares to provide the highest returns over the long term because they have the highest short-term risk. What you are then doing is letting compounding work for you over the long term. Underpinning the sharemarket is growing corporate profits in an expanding economy.

Costs: the silent killer

Cost is one of the most crucial aspects of an investor's return equation. What you get in your pocket is what the fund earns after the costs are taken out. If the costs are high it's unlikely your return will be high. As our founder Jack Bogle likes to say, "You get what you don't pay for" – a good line because it happens to be true. What makes funds attractive is compounding returns. Compounding an 8 per cent or 10 per cent return over time can generate huge portfolios over 10, 20 or 30 years. But if costs are 25 per cent of the equation, the return will be much less and the benefits of compounding reduced. Investors often fail to understand that; we know this from surveys. Yet we also know it's one of the few ways investors can really differentiate between funds.

Performance: it's all history

The biggest error people make is to invest on the basis of past performance. But you can't buy the past performance of a market or funds manager. Instead, you've got to look to the future and unfortunately past performance has very little to do with future performance. What investors don't realise is that there's a lot of luck in this game, and sometimes it's hard to tell the difference between luck and skill.



holidays than they do their retirement. This reality about people's priorities is a good argument for the simplicity of index funds – long-term investment horizons with a low cost for people in the workforce. And they are a boon for busy people (often running small businesses) with do-it-yourself superannuation funds.

Savings habits: learn early

Our US CEO, Jack Brennan, says the most important lesson is: spend less than you earn. In other words, develop a savings culture early in life. Make it a regular event so that compounding works for you. Even at 25 try to pay more than the 9 per cent superannuation levy. It will make a big difference.

Currency: too hard

Very hard to forecast so don't try. Long term we don't think the currency makes that much difference; it tends to wash out. Certainly you can't have an informed opinion on whether the currency will be weak or strong in 25 years.

Geo-politics: read those headlines

Has a significant impact on markets. Today, Australia is benefiting from being part of the burgeoning Asian region, particularly China, with its healthy appetite for commodities. But remember to always diversify. Don't get over-enthusiastic about a certain market or economy. It's always easier with hindsight to see what markets to avoid; it's much harder looking forward.

Active fund managers: it's all uphill

The challenge for active fund managers and active investors, for that matter, in picking the right stocks is that they are competing against other professionals. Sometimes they win; sometimes they lose. It's like an Aussie Rules game between top sides – you never know which team will win. And the costs are high – like a casino, the house must be paid. Sometimes the take is explicit and sometimes it's hidden. Typically an active retail fund in Australia charges investors 1.75 per cent a year and nearer to 2 per cent a year for an international fund. That's a big bite out of the return; if that's 1 per cent above the cost of an index fund that's 1 per cent the active manager has to make before he's ahead. Then there are transaction costs – these might be anywhere between 0.5 per cent and 1 per cent a year – and tax costs, typically higher for an active manager because they are regularly turning the portfolio over. 🏠

Market timing: more lows than highs

It's almost impossible to pick market tops and bottoms. What most investors don't realise is that it's not getting one decision right but two – when to get out and when to get back in. You have to get it right twice and then do it consistently to make money from a market-timing strategy. The other thing that kills you with a market-timing strategy is that the costs are bigger than you expect. When you sell out or buy into an investment you've got costs, such as sales commissions or tax, and these can really hit you.

Tax: talk to an expert

Get an adviser. The one thing I've been constantly reminded of since returning home is just how complicated our tax and superannuation systems are. That said, superannuation does offer nice tax advantages – 15 per cent versus up to 48.5 per cent. There are also lower taxes on the earnings you accumulate in superannuation. Remember, too, the enormous tax advantages of shares relative to cash and bonds. It surprises me the number of people who put money into an internet banking account at 5.4 per cent but if they're paying 48.5 per cent tax on that do they realise there's only 2.8 per cent left after tax. In a share account you get to pay only half the tax rate on your long-term capital gain (that's capital gains held over 12 months) and you get valuable franking credits on Australian shares.

Investing time: the rewards will come

Typically most investors do not devote enough time to their investments. It's like the dentist who doesn't look after his children's teeth. Research tells us people spend more time planning their

What super's new rules mean

With changes to superannuation rules, you have more power than ever over your future. By Michael Houlihan

The year 2005 has seen some significant changes to superannuation. Below is a summary of key changes together with details on what is proposed for 2006.

What has happened?

Choice of Fund

With much fanfare, the choice of fund legislation came into effect on 1 July 2005. These new rules allow each individual worker, subject to certain exceptions, to choose his or her own superannuation fund. With this new found flexibility it was interesting to note that very few people took up the option to change their superannuation fund when the calendar ticked over on 1 July.

Just as a reminder, the general rules that surround the choice of fund regime are:

- your employer must give you a standard choice form within 28 days of you starting employment
- once you have completed the standard choice form, your employer has two months to start the payment of contributions
- your employer must have a default fund which would be used in the circumstances where you do not make a choice.

Another aspect to consider is that if you are employed under a workplace agreement or enterprise bargaining agreement then the provisions of those agreements may override the choice legislation.

Transition to retirement

Superannuation law has been amended to implement the Government's transition to retirement measures. These measures were announced by the Treasurer on 25 February 2004, in "A more flexible and adaptable retirement income system".

From 1 July 2005, superannuation funds are allowed to pay superannuation benefits to a member who has reached their preservation age (age 55 to age 60 depending upon the person's date of birth) but has not retired from the workforce. This is allowed only if the benefit is taken in the form of a non-commutable income stream, such as an allocated pension or a market linked income stream. These changes are optional for superannuation fund trustees.

Allowing people to access their superannuation from their preservation age without having to retire or leave their job will give them more options to consider in their lead-up to retirement. As an example, you may now choose to continue working part-time, using part of your superannuation to supplement other employment income, without having to leave the workforce altogether.

Removal of the surcharge

The superannuation contributions surcharge, introduced in 1996, was levied based upon your salary or taxable income. This extra impost has been seen as an unnecessary burden to people who are genuinely saving for retirement. In May 2005, the Federal Treasurer, Peter Costello, announced the abolition of the super-

annuation contributions surcharge as part of the 2005-06 Federal Budget. As a result, the surcharge does not apply to any superannuation contributions made, or termination payments received, in relation to the period since 1 July 2005. Surcharge obligations are still payable in respect of 2004-05 and previous financial years.

What's coming up in 2006?

Contribution splitting

New rules are expected to soon be implemented that will give members of superannuation funds a greater say in how to make and allocate their superannuation contributions. Changes to superannuation law that are expected to come into effect from 1 January 2006 will now enable members of superannuation funds to elect to "split" their contributions with their spouse. The intent of these new rules from the Government's perspective is that the splitting of contributions will assist families to maximise the benefits available in superannuation and provide an avenue for spouses to share in superannuation benefits.

These new rules will allow you to split up to 100% of your personal (after-tax) contribution and up to 85% of your employer (pre-tax) contribution. The employer contributions include the compulsory superannuation guarantee contributions as well as any salary sacrifice contributions.


Changes to pension rules

After many months of negotiation, the Government has released draft regulations affecting pensions being paid from superannuation funds. These regulations are intended to take effect from 1 January 2006:

- extend the maximum term of the market linked and other life expectancy income streams so that payments continue until the recipient reaches age 100 (or until a person's spouse reaches 100)
- allow annual payments of the market linked income stream to vary between plus or minus 10 per cent of what would have been calculated under the normal payment rules
- update allocated pension (and annuity) drawdown factors in line with current life expectancy, effective from 1 January 2006.

Bankruptcy and superannuation

Back on 16 December 2003, the Government issued a release announcing amendments to the Bankruptcy Act 1966 so that certain superannuation contributions made prior to bankruptcy can be recovered by bankruptcy trustees. The Government has now issued a consultation paper titled "Effect of Bankruptcy on Superannuation Contributions" for industry comment.

In summary, bankruptcy trustees would be able to recover from a bankrupt's superannuation plan contributions funds above a certain annual threshold amount made during the period beginning on the day five years before the start of the bankruptcy and ending on the day of the bankruptcy. 

First to report after-tax returns.

You could say we're at the Vanguard.

Accountants understand the importance of after-tax returns. So does Vanguard. That's why Vanguard was the first fund manager to report after-tax performance. After all, it's what's left in the investor's pocket that counts!

Our "buy and hold" strategy takes advantage of capital gains discounts and the deferral of capital gains liabilities.

Lower fees and low overall costs make Vanguard even more attractive. Indexing is inherently a low-cost

investment approach. There's none of the frantic buying and selling that drives up the costs associated with active management.

Vanguard's indexing approach also offers the benefits of diversification, which reduces risk.

For people who value after-tax returns, contact Vanguard for more information on 1300 655 101 or visit our website www.vanguard.com.au

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Indexing's simple truths

When you do the sums you'll find one simple message about indexing: it works.

There are many ways to demonstrate that indexing as an investment strategy works. But one will do quite adequately. When the index innovator Vanguard first opened its doors for business in the United States in 1975 it had 11 mutual funds and about \$US1.8 billion in assets. Today, Vanguard's index assets under management are approaching \$US400 billion. Founder Jack Bogle's dream, which he calls the "Vanguard experiment", has surely come true.

Bogle's dream was to start a revolution in the mutual funds industry in the US – that funds should be managed solely in the interests of their shareholders. Vanguard introduced the first public indexed fund in 1976, introducing the concept of tracking the performance of a market index and effectively offering the returns – before fees – of that index.

Underpinning indexing is recognition of the need to invest for the long term. Index funds – especially equity funds – are not suitable short-term investment vehicles: calling stocks "winners" and "losers" is absent from the lexicon of indexing. Rather, the focus is on having a wide range of assets within a specific index that are then held for the long term (it's called "buying and holding"). By adopting this approach index funds remove the need to predict a market's highs and lows and it cuts costs, boosting returns to investors.

Eric Smith, principal and chief investment officer of Vanguard Investments Australia, agrees that indexing is somewhat counter-intuitive. He says: "There's the sense that if you don't try you won't win – a bit like buying a lottery ticket. But what are your chances of winning the lottery? And your chances of picking an active manager who will outperform the market are a bit better than that, but not a great deal better.

"You only have to look at the performance of Vanguard's retail funds to know that over three, five or seven-year periods it outperforms more than half the active managers. Yes, there's always somebody you can point at who's had a better result. The problem for the investor is to determine who that fund manager will be before it happens. You can always select on the basis of last year's performance; you can't buy it. But the index fund, because it's not trying to be a winner, is very unlikely to be a loser. For me, the logic says indexing is the way to go, especially when it comprises the core area of any investment portfolio."

To Smith, the notion that investing in an index fund will – over time – consistently deliver better returns than

active fund managers is almost a no-brainer. He says: "What all fund managers are doing is capturing market return. If they're an active manager they're trying to add some cream to that return. That's what they're offering, but they're charging a significant fee to do so. And this sets a hurdle that's almost impossible for active fund managers to consistently jump over.

"People struggle with the concept that smart people can't make a difference. But they're all smart people and they're punting against each other – and the house is taking a cut (the fund manager's fees). The collective performance of all those people can't be better than the market. It's the zero-sum game argument; for you to win someone else has to lose."

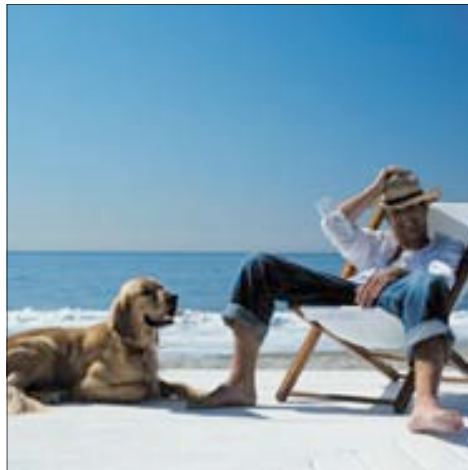
Although the principles behind indexing are simple – long-term investing in a diversified portfolio, low costs and tax efficiency – the actual process involved in achieving this result is not straightforward. Smith says: "It's not a mechanical exercise. At the asset class level, we tend to choose indexes that have broad coverage. So we track the S&P/ASX 300 for the Australian share fund. Why? Because it's got another 100 stocks compared with the S&P/ASX 200, which is the index that tends to get promoted these days. The extra 100 stocks only give you two cents in the dollar, but we still see it as valuable.

"Capitalisation weight is important. The fact you are investing more in the BHPs of the market is because they're a bigger part of the global economy. Free float adjustment is also pretty much universal now. All it means is that instead of using all the shares on issue as representing the index, it adjusts for holdings that are not traded. An obvious example in our market is the Federal Government's stake in Telstra."

Smith concludes that because most people invest for the long term their focus should be on growth and, over time, it's equities that will best provide that growth.

"In the long term, timing doesn't matter. But for many when to get in and out of a market has a real appeal. The trouble is no one rings a bell to tell you when to get back in. And as markets go up more often than they go down then if you're out of the market you're more likely to lose.

"If you invested in September 1987 before the crash it was not before 1994, seven years later, that you were back to square one. That excludes dividend income, but that's all you got for seven years. But if you persisted and stayed in until now you've had a great time, especially if you've had a diversified portfolio. That's the value of the long term." #



Buyer's pick: 8 top investment reads

If that get-rich-quick scheme looks too good to be true, then it probably is. A better path to wealth may lie in books.

As many investors know from bitter experience, they are prone to following the latest fad or listening to industry hype. Whether it's the mining boom of the early 1970s or the high-tech boom of the late 1990s, many investors - too many - believe in these get-rich-quick schemes.

If you are such an investor, if you are still looking for investment nirvana, then the following eight books are not for you. The target audience of these books, all written by eminent financial commentators, is for investors who want to take a long-term view and who realise the importance of asset allocation.

The authors not only avoid the hype and fads that often surround investing; they take issue with it. Many of these books expound the ideas behind Vanguard's investing approach. In particular, Vanguard founder, "Jack" Bogle, is highly critical of an industry for confusing investors with highfaluting language and complex strategies when the simple approach is typically the best.

None of these books will make you wealthy. But all will help you accumulate wealth. Janene Murdoch, proprietor of the Melbourne bookshop Educated Investor, sums it up succinctly: "A good investment book will not make you a millionaire. But it will teach you the basics about investing for the long term and that's the first step to becoming a successful investor." The books' authors could not have put it better.

Bogle on Mutual Funds: New Perspectives for the Intelligent Investor by John Bogle. *McGraw-Hill (US)*. 1994. \$65.95 (hardback). Bogle has been one of the mutual funds industry's greatest leaders - and one of its greatest critics - and this book benefits from both perspectives. It explains the basic principles of investing for the long term, and how to avoid those investment fads that often lure the unwary into making bad decisions.

straight talk on investing: What You Need to Know by Jack Brennan. *John Wiley & Sons (US)*. 2002. \$US22.95 (hardback). The chairman and chief executive of Vanguard, Jack Brennan, has put more than two decades of experience in investment markets to good use in this book. He offers simple, straightforward advice, stressing that investment is not as stressful as many in the industry like to make out. It's all there: the financial facts of life, who to trust (and who not to trust) and how to develop a savings culture.

Wealth of Experience by Robin Bowerman & Jeremy Duffield. *Wrightbooks (Australia)*. 2002. \$24.95 (paperback). The managing director of Vanguard Australia, Jeremy Duffield, joined forces with

the former managing editor of *Personal Investor*, Robin Bowerman, to bring to readers the experiences, views, insights (as well as the odd disaster) of more than 1000 investors. It makes for a fascinating read, all the more so because it comes with expert commentary and sage advice in an easy-to-read style.

The Battle for the Soul of Capitalism by John Bogle. *Yale University Press (US)*. 2005. \$US25 (hardback). Few people are as well qualified to take a long hard look at the US financial system than Vanguard founder John Bogle. In this rivetting read he takes aim at corporate America, arguing it has nearly derailed the country's capitalist system. For individual investors, it offers great insights into the financial system, and how to ethically profit from it.

The Barefoot Investor by Scott Pape. *Pluto Press (Australia)*. 2004. \$24.95 (paperback). Offers a financial vision for people in their 20s and early 30s. Covers all asset classes - as well as debt, credit cards, etc. He writes in a way that connects to this age.

A Random Walk Down Wall Street by Burton Malkiel. *W.W. Norton & Company (US)*. 2003. \$US29.95 (hardback). This book is regarded as one of the great guides to smart investing. First published in 1973, Malkiel takes readers through the investment minefield that is Wall Street, arguing that simply buying and holding shares in a broad index is likely to produce a better result than paying high fees to a professional using sophisticated analytical techniques.

Winning the Loser's Game: Timeless strategies for successful investment by Charles Ellis. *McGraw-Hill (US)*. 1975. \$36.75 (paperback). Now in its fourth edition, this book, which has its genesis in an award-winning article written by Ellis in 1975, has become one of the bibles for investors. It combines technical analysis with fascinating insights and a historical perspective to really give investors a chance of winning.

Common Sense on Mutual Funds: New Imperatives for the Intelligent Investor by John Bogle. *John Wiley & Sons (US)*. 1999. \$32.95 (paperback). Bogle has spent a lifetime in the industry championing the rights of the fund shareholder, and this book shows how. Amid the cacophony of advice today, this book's central message - to embrace simplicity when investing - is as valid today as it was when he entered the industry about four decades ago. 📖

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