Vanguard®

Core investing principles help lay a foundation for success

Vanguard Research Brief | October 2017

Key points

- Since its inception, Vanguard has adhered to a core investment philosophy to help guide the investment decisions our clients make.
- This philosophy manifests itself in Vanguard's four fundamental principles—goals, balance, cost and discipline—that are within an investor's control. Following them can help tune out the "noise" that can derail investors' progress toward reaching investment goals.
- Even sophisticated investors can find themselves subject to emotional investing and should arm themselves with a long-term perspective and a disciplined approach.

This paper explores Vanguard's four principles and how investors can use them to help make decisions that give them the best chance for investment success.

Investors may be tempted to focus on the markets, the economy, manager ratings, or the performance of an individual security or strategy. In Vanguard's view so much "noise" can complicate investors' decision-making and lead to their overlooking the fundamental principles we discuss here. Instead, investors should focus on those things within their control. Our four fundamental principles embody such an approach.

Goals: Create clear, appropriate investment goals

Appropriate investment goals are measurable and attainable. Success shouldn't depend upon outsize investment returns or impractical saving or spending requirements. Defining goals clearly and being realistic about ways to achieve them can help protect investors from common mistakes that can derail progress.

Without a plan, investors often build their portfolios bottom-up, focusing on each investment holding rather than on how the portfolio as a whole is serving the objectives. They may indulge in "fund collecting"—buying seemingly attractive funds without thinking about how or where they fit within the overall portfolio allocation.

Balance: Develop a suitable asset allocation

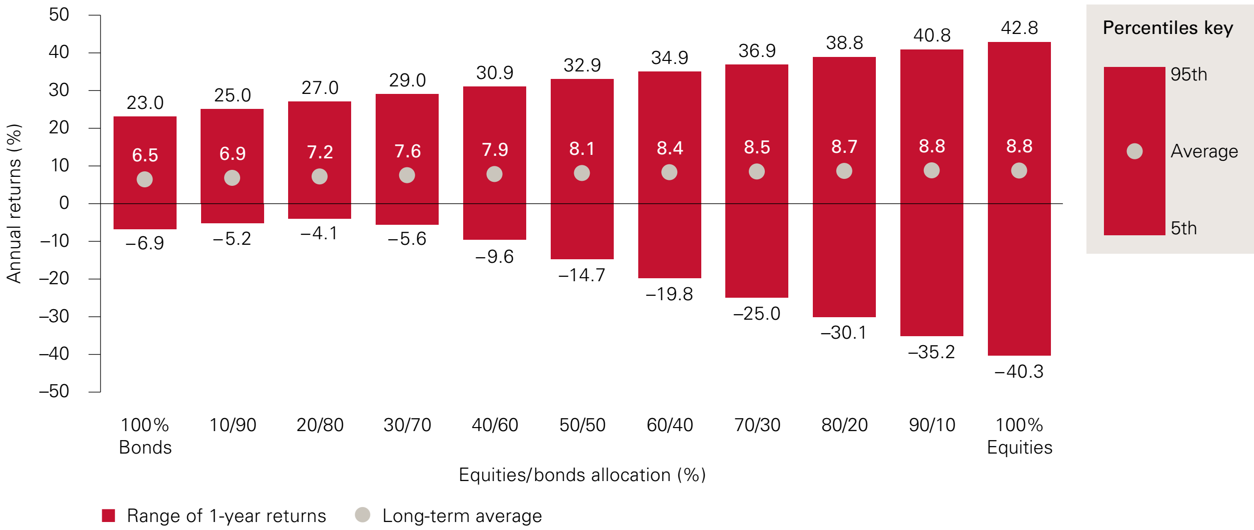
A sound investment strategy starts with an asset allocation suitable for the portfolio's objective. The allocation should be built upon reasonable expectations for risk and returns. It should also use diversified investments to avoid exposure to unnecessary risks.

Assuming that an investor uses broadly diversified holdings, the mixture of those assets will determine both the returns and the variability of returns for the aggregate portfolio. Attempting to escape volatility and near-term losses by minimising equity investments can expose investors to other types of risk, including the risks of failing to outpace inflation or falling short of an objective.

Figure 1 on page 2 shows a simple example of this relationship using two asset classes—global equities and global bonds—to demonstrate the effects of asset allocation on both returns and the variability of returns. The middle numbers in each bar show the average yearly return since 1985 for various combinations of equity and fixed income. The bars represent the 95th (top of bar) and 5th (bottom of bar) percentile one-year returns. Although this example covers one specific holding period, it shows why an investor whose portfolio is 20% allocated to global equities might have a very different outcome from an investor with 80% allocated to global equities.

Figure 1. The mixture of assets defines the spectrum of returns

Best, worst and average returns for various equities/bond allocations, 1985 – 2016



Note: Equities are represented by the MSCI World Index (USD) and bonds are represented by the WD Citicorp WGBI World Index (USD).
Source: Bloomberg.

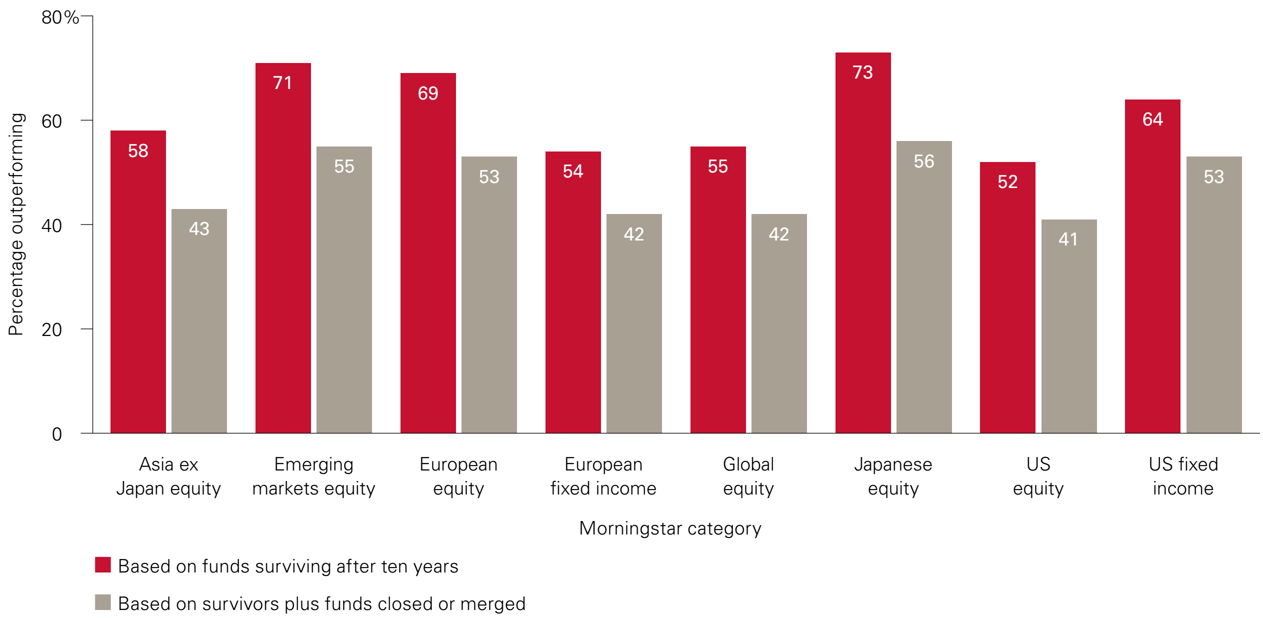
Cost: Minimise expenses

The lower the costs, the greater an investor's share of an investment's return. In addition, Vanguard research suggests that lower-cost investments have tended to outperform higher-cost alternatives.

Index funds and ETFs tend to have low costs. As a result, index investment strategies can offer the opportunity to outperform higher-cost active managers—even though an index fund simply seeks to track a market benchmark, not to exceed it. Although some actively managed funds have low costs, as a group they tend to have higher expenses.

Data support the outperformance of indexed strategies, especially over the long term, across various asset classes and sub-asset classes. **Figure 2** shows how US-domiciled low-cost funds as a group may often do better than actively managed funds within common asset categories over the ten years ended 31 December 2016. Unfortunately, similar data were unavailable in Hong Kong for a long enough history, but the US experience would be expected to carry over to the Hong Kong market.

Figure 2. Percentage of active funds outperforming the average return of index funds



Notes: Data cover the ten years ended December 31, 2016. The actively managed funds are those listed in the respective Morningstar categories.
Source: Vanguard calculations using data from Morningstar, Inc.

Discipline: Maintain perspective and long-term discipline

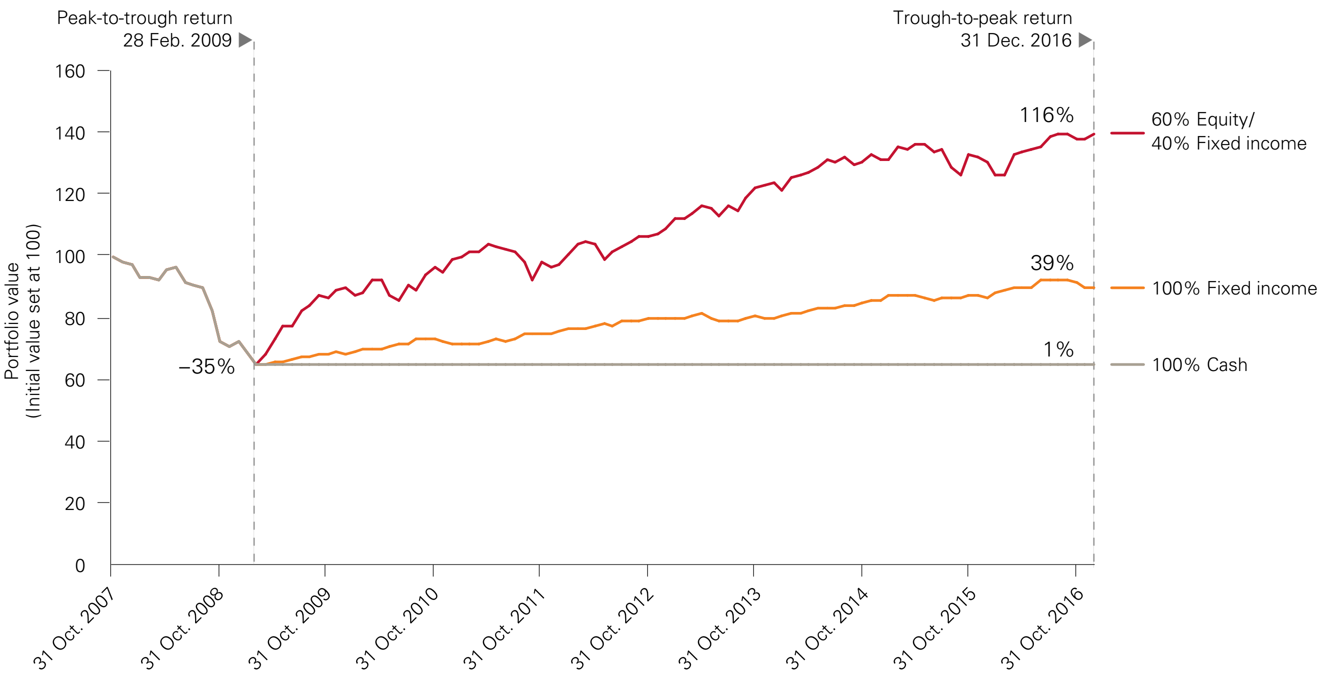
Investing can provoke strong emotions. Amid market turmoil, some investors may make impulsive decisions or, conversely, may become paralysed, unable to implement an investment strategy or to rebalance a portfolio as needed. Discipline and perspective can help investors remain committed to their long-term investment programmes through periods of market uncertainty.

Although the asset allocation decision is one of the cornerstones for achieving an objective, it works only if the allocation is adhered to over time and through varying market environments.

Figure 3 shows the impact of fleeing an asset allocation during an equity bear market. In this example, the investor moves out of equities on 28 February 2009, to avoid further losses. While the 100% fixed income portfolio experienced less volatility, the investor who chose to stay with the original asset allocation recovered most completely from the setback to earn a superior return.

Figure 3. The importance of maintaining discipline: Reacting to market volatility can jeopardise return

What if the "drifting" investor fled from equities after the 2008 plunge and invested 100% in bonds or cash?



Notes: October 2007 represents the equity peak of the period, and has been indexed to 100. Assumes that all dividends and income are reinvested in the respective index. Equities = MSCI AC World Index in USD, fixed income = Bloomberg Barclays Global Aggregate Index Hedged in USD, cash = Citigroup 3-Month US Treasury Bill Index.
Source: Vanguard, using data provided by Datastream.

The key take-away

Because investing evokes emotion, even sophisticated investors should arm themselves with a long-term perspective and a disciplined approach. Abandoning a planned investment strategy can be costly, and research has shown that some of the most significant reasons for derailment are behavioural: the failure to rebalance, the allure of market-timing and the temptation to chase performance.

Far more dependable than the markets is a programme of steady saving. Making regular contributions to a portfolio, and increasing them over time, can have a surprisingly powerful impact on long-term results.

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