John Bogle: Retirement investors leave 80% on the table

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Figure 1John C. "Jack" Bogle, founder of the Vanguard Group, speaks during a panel discussion at the John C. Bogle Legacy Forum.

Bloomberg

The headlines pulled no punches after a poor January and a tough start to February for stocks: "Brutal" said one, "horrific" said another.

The natural human compulsion in such times is to take action. Yet before investors really absorb such headlines, the time for action will have passed. And that's the problem.

The solution, to cite Vanguard Group founder John Bogle, is to do nothing at all. While that sounds like a weak strategy, it's the only strategy retirement investors should consider.

Here's why: You aren't a hedge fund. You aren't paid to manage other people's money. You aren't compensated for the time you spend reading headlines on finance websites or poring over earnings.

Nobody gives you a bonus at the end of the year for attracting more money to your fund or for going on TV to blather about global politics. You simply aren't a money manager.

The difference is subtle but important. As a retirement investor, it's likely that you feel the urge to actively "run" your own money. But the incentives aren't there. It isn't your job. At best, it's an expensive hobby.

Wall Street would prefer that you think, and behave, otherwise. The whole structure of the retail investment business rests on the mistaken notion that small investors have a role to play.

They don't. In fact, retail buying and selling at a breakneck pace during market setbacks is exactly how Wall Street makes its living, through commissions and by trying to take the other side of whatever trade you might be pondering.

Bogle put it this way in a recent column online:

"While the interests of the business are served by the aphorism 'Don't just stand there. Do something!' the interests of investors are served by an approach that is its diametrical opposite: 'Don't do something. Just stand there!'"

Do nothing? Just sit still and watch the market fall? Yes, that's right.

Life lessons

In part, it's right because there's no way for you to react with enough speed and agility to affect the outcome. But it's also because reacting costs you money — big money.

Having the overwhelming urge to react to a market decline isn't smart investing. It's reacting, and that's all. If you are a young, long-term investor with decades ahead to save, falling stock prices is great news, a chance to layer into positions at lower prices.

If you are near-retiree with a properly allocated portfolio, the last few weeks have been an interesting blip on your radar and nothing more. Something to gab about, perhaps, but by no means a real problem that requires action today.

However, if you are an older investor near retirement who is nevertheless acting like a young investor, well, yes, you should be worried. And that's where the big money comes in.

Chances are high you will wait before selling it all. And wait. And wait some more. Right about when stocks finally bottom — in a week or a month or midyear, whenever it happens — that's when you will sell, locking in your losses permanently.

The young investor who commits this kind of mistake can recover. In fact, it can be a "good" mistake to make, a life lesson if you will. If you are older, there is no room for error.

There are two fundamental pieces of math to remember here. The first is about percentages.

If you have $100,000 and the market makes a 10% correction, your investment is now down to $90,000. You decide to sell. Question: What return do you need to recover?

If you said "10%," pull out a calculator and try again. You need more, about 11.1% or so, to get back to even — if you sold the investment. To recover from a 20% loss you need a 25% return. The farther down you cash out, the bigger the gain you need to get it back.

Winning long

The second piece of math is courtesy of Bogle. If you pay a hefty fee to an active manager, what happens to your potential return?

Answer: Nothing good. At 2.5% over a typical investor's lifetime, an astounding 80% of compounding returns ends up in the hands of the manager, not the investor, by Bogle's calculations.

Says Bogle: *"When our financial system — essentially our money managers, marketers of investment products and stockbrokers — put up zero percent of the capital and assume zero percent of the risk yet receive fully 80% of the return, something has gone terribly wrong in our financial system."*

To put it another way, the retirement investor should be like a wily boxer. Don't get worn down by the nasty punch of investment fees or let yourself be knocked out by selling at a market bottom.

Wall Street wants you to throw wild punches that will tire you out. If you can stay on your feet for all 12 rounds, compounding will guarantee you a win by decision.