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Please accept this *Patient Subscriber's Bonus Edition* as a token of our appreciation for your patience and support in 1997 and always:

THE VANGUARD GROUP'S JOHN BOGLE

SIMILARITIES BETWEEN 1929 AND TODAY ABOUND — INCLUDING RECORD VALUATIONS AND MORE.

John Bogle, Chairman of the Board of Vanguard, has long been a leader in the mutual fund industry as well as one of its most outspoken critics. According to Don Phillips, publisher of *Morningstar Mutual Funds*, "...Bogle is both [the fund industry's] harshest critic and its greatest friend. He is, in effect, the conscience of the industry, constantly reminding his compatriots that fund companies must always put investors' interests first...."

And Warren Buffett has called *Bogle on Mutual Funds*, "...the definitive book on mutual funds — comprehensive, insightful, and — most important — honest."

He commented on the current investment scene before the World Affairs Council of Philadelphia in August. We believe the following excerpts from his comments on that occasion remain relevant today and hope you agree.

So far so good. But where do we go from here?

John Bogle: In this booming stock market, it sometimes seems as if everybody is getting rich. That may seem a bit strong. But the 36% of the American public who own mutual funds are *indeed* getting richer — seemingly every *day*. We're at the pinnacle of an historic 15-year bull market. And the question I'll try to address today is, "Where do we go from here?" It's a good question.

The 1990s decade began with five so-so years where equity returns were rather mediocre — only 8.7% per year. But in the 2-1/2 years since, (3/4ths of the 1990s, believe it or not, have now flown by), on an annualized basis, returns have averaged 33%. The Dow Jones Average, which only advanced from 2700 to 3800 in the first half of the decade, has now in a period *half* that length soared above 8000.

Valuations have reached extraordinary, worrisome peaks.

Bogle: Earnings from companies in the S&P Index, after going *literally* nowhere — unchanged at $25 a share from 1988 to 1992 — have now nearly doubled to an expected $46 in 1997 (the bulls say $48)....

Valuations have reached *extraordinary* and new worrisome peaks. Even [from] the fairly high valuations in place when stocks took off early in 1995, the ratio of the market's price-to-book has risen from 4 to 6-1/2 times. And the P/E ratio has risen from 15 times to 20 times.

Dividend yield, (yes, I'm old-fashioned enough to believe that dividends still matter,) has fallen from 2.7% to 1.6%. Only at the 1929 peak, the 1973 peak, and the 1987 peak did the dividend yield ever get as low as 2.7%. And now it's 1.1% below *that*.

[Editor's note: According to *Barron's*, the S&P 500 today sells at 5.1 times book, 22.8 times earnings and provides a dividend yield of 1.7%.]

A rising tide hasn't lifted boats (as much).

Bogle: To make matters worse from the standpoint of a lot of investors, the passive, invisible hand of the market is putting to shame returns earned by active managers who don't buy the market.... For example, while our passive S&P 500 Index Fund is up 104% in this 2-1/2 year boom, the average actively managed mutual fund is up [only] 74% [and] the average international fund is up just 37%....

This time it's *different*? It certainly *sounds* familiar....

Bogle: In all, similarities with 1929 abound. I don't hesitate to haul up the warning flag. Worrisome signs include not only high valuations, but the similarity of the words we read today with those of a now forgotten era.

For example, a U.S. President says,

"No Congress ever assembled on surveying the state of the union, has met with a more pleasing prospect than that which appears at present. In the domestic field, there is tranquility and contentment and the highest record of years of prosperity."

— Calvin Coolidge, December 4th, 1928.

A financial article states, (and this is pretty stinging),

"The establishment of mutual funds by banks and independent groups has almost become a fad. The public appetite for them grows even more rapidly than the *funds* can. They represent buying power in the [stock] market that appears to be without a saturation point."

— *New Levels in the Stock Market*, August 1929.

OF COURSE, THE BULLS COULD BE RIGHT. BUT, FOR THEIR SAKE, THEY'D *BETTER* BE.

Valuation/fundamentals discrepancy must be resolved....

Bogle: In short, it seems that speculation — betting on higher and higher valuations — is in the driver's seat. Investment, betting on the fundamentals of dividend yield and earnings growth, is in the back seat, probably even in the *rumble* seat.

[But] while speculation drives stock returns in the

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JOHN BOGLE'S
INVESTMENT OUTLOOK
(cont'd from preceding page)

short run, a crystal clear lesson of history — at least of the past 200 years — is [that] in the long run, *fundamentals* drive returns. So that tension must be resolved.

Let me give you two extreme possibilities. [Possibility number] one: a market drop of 35% — just for the fun of it — would lower price/earnings ratios to a more normal level of about 13 times. And at 5,200 in the Dow, we would *still* repose, I might add, fat, dumb and happy where we sat in January 1996, just a year and [a] half ago. This is hardly a doomsday scenario.

The bulls' case is quite beautiful....

Bogle: [Possibility number] two: we're in a new era in which stock returns average 15% [per year], (14% from earnings growth and 1% from dividend yield), rather than the long-term historic norm of about 10-1/2%, (6-1/2% from earnings growth plus 4% from dividend yield). In short, a new era of boom times and high valuations ... justify today's high price levels....

The bulls' case is quite beautiful. You should hear it. It's exemplified by a recent article in *Wired* magazine. I don't know how many of you read *Wired*, but you can get it on www.wired.com/5.07/longboom for July 1997. It's entitled "The Long Boom" with the subtitle, "We're facing 25 years of Prosperity, Freedom, and a Better Environment for the Whole World. You got a Problem with That?"

No, I got no problem with that. Who among us could *possibly* have a problem with that? "We're watching," quoting from the article, "the beginnings of a global boom on a scale never experienced before. We've entered a period," it continues, "of sustained growth that could eventually double the world's economy every dozen years and bring increasing prosperity for quite literally billions of people on the planet. It will do much to solve seemingly intractable problems like poverty and ease tensions throughout the world — all without blowing the lid off the environment."

What a scenario!

And it could happen. But I wouldn't bet the ranch....

Bogle: The thesis ... is based on the triumph of the U.S., the end of major wars, new technology, a truly global market, corporate restructuring, high economic growth and waves of technology. "A virtuous circle", the magazine calls it, "driven by an open society and an integrated world. As a result, the Fed lifts its foot off the brake, productivity soars, biotechnology revolutionizes agriculture, alternative sources of energy abound, Europe is integrated by 2002, Russia has a solid economy by 2005, and China develops the world's largest economy by 2020." All in all, "a radically optimistic meme...."

"Meme", incidentally, is not in the dictionary. But I'm told it means "a contagious idea that replicates like a virus

(continued in next column)

passed on from mind to mind".... So we have a *new* one — apparently. Now, of course, it could happen. But I wouldn't bet the ranch on it. The U.S. stock market, however, *seems* to be betting the ranch on it. It's priced, I think, for the best of times and *only* the best of times....

THE OLD CHINESE CURSE IS TRUE TODAY.
BUT THESE PRINCIPLES MAY HELP....

These are certainly interesting times....

Bogle: Well, we've all been favored with the fruition, as it turns out today, of the ancient Chinese curse — "May you live in interesting times." They are especially interesting with stocks soaring to unprecedented heights and new forces of technology and globalization permeating our world. We can't walk away from it, so deal with it we must.

[Therefore], let me close with five simple principles — a few ideas of what you might want to think about — principles of investing that may help you.

(1) Never think you know more than the market.

Bogle: First, invest you *must*. The biggest risk is the *long*-term risk of not putting your money to work at a generous return, not the short-term, albeit *real*, risk, of price volatility. Even though stocks seem very high, as I said in my book, (a little plug), never think you know more than the market. You're apt to be wrong if you do.

(2) Time is on your side. Don't wait to get started investing.

Bogle: Second, give yourself all of the time you can. At the extremes, if you're in your 20s, begin to invest in stocks even if you've only got a little bit to invest. If you're in your 60s, invest more in bonds and less in stocks. But always remember that compound interest is a miracle and time is your friend.

(3) Have rational expectations. Emotions can kill you.

Bogle: Third, have rational expectations about future returns and be mentally prepared for a market decline. Always remember in good times and bad times alike that, "This too shall pass away." I spend a full page of my book on that sage piece of wisdom — that this too shall indeed pass away — because your emotions can *kill* you. You should always keep them out of your investment program because *impulse is your foe*.

(4) Use sensible asset allocation and keep an eye on cost.

Bogle: Fourth, rely on simplicity — simplicity above all. There are too many witch doctors in this business with too many patent medicines. Basic investing is *simple*: a sensible asset allocation to stocks, bonds and reserves, a middle-of-the-road selection of diversified funds, a careful balancing of risks and returns.

And, lest we forget, *cost* can kill long-run returns. Don't disregard low-cost index funds, (my only plug)....

(5) No matter what happens, stay the course....

Bogle: And, lastly, when you follow these four rules — as I said and I've meant 1,000 times if not 10,000 times — no matter what happens, stay the course....

— OID