



## 119 – Invest Like a Nobel-Nerd Episode Transcription

*“Indexing is often billed as the solution to all ills of the financial markets. But even indexing has some issues.”*

Paul Adams: Indexing is often billed as the solution to all ills of the financial markets, but even indexing has some issues. For instance, if you buy a mid cap index fund, what will inevitably happen is there's drift inside that fund before the index creators reconstitute it every year. Some of the mid cap funds float above over the year, and now they're large cap funds, or they float below and now they're small cap investments inside your mid cap fund until they go back and reconstitute.

Announcer: Welcome to Sound Financial Bites where we help you with bite-sized pieces of financial and life knowledge to help you design and build a good life. The knowledge that has been shared from stages at conferences, pages of national business magazines, and clients living across america our host, Paul Adams, now brings directly to you.

Paul Adams: Hello and welcome to Sound Financial Bites. I am Paul Adams, CEO and founder of Sound Financial Group. I am joined by my co-host, Cory. Cory, where are you? Did you think I was going to say more about you? I don't know why you just sat there quietly.

Cory Shepherd: I was wondering if we were going to start like a ... I jumping the gun. "I'm Paul Adams-" And I'm Cory Shepherd, president of Sound Financial-

Paul Adams: I just figured I would throw you with super awkward stalls, so hopefully our audience enjoyed that. I don't know if you all enjoy me making Cory uncomfortable. I love it, so hopefully we share that in common.

Cory Shepherd: And I am the president of Sound Financial Group and co-host of Sound Financial Bites.

Paul Adams: Second podcast ever as co-host. Prior to this, our staff had always put him down as a special guest. I think they were thinking, "Maybe he'll be gone any day." But he has stuck around and therefore earned the title of co-host.

We're going to talk a little bit about investing like a Nobel nerd. We talked in our last podcast about the kinds of things that aren't disclosed to you. What you don't know can hurt you. If you haven't heard this podcast, I encourage you after this to go back to that one to really let you know why we're taking the time to talk about these issues.



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But before we jump into today's content, I just want to separate the kinds of investing somebody can do when you invest in the market into three separate categories. In our last episode, we talked a lot about active investing. Active investing, where some stock manager says they are going to trade in the market for the sake of out-performing what the market would have done anyway either on the upside or on the downside. That is generally referred to as active management. There is the greatest amount of marketing dollars being put behind active management than any of the other types I will talk about here today. It is a marketing machine. And unfortunately the academic evidence shows us over and over again that active management doesn't work out.

I refer you back to our Illusions of Investing series. You can find that in our podcast. You can find that in our YouTube, but it will give you deeper insight into that. If that concept of active managers being wildly ineffective and unable to even predict which managers will do well in the future, if that sounds foreign to you, go back to Illusions of Investing on our YouTube or our podcast. It'll take care of that for you.

The next part, that is often billed as the solution, it's a little bit like ... What's one of those, like they come out with some new thing like elderberry or whatever and they're like, "It'll cure anything."

Cory Shepherd: Or the newest diet book.

Yeah, like, "You rub elderberry on your brakes; they'll stop squeaking. You can drink it; it'll cure pneumonia."

Cory Shepherd: Windex, everything.

Paul Adams: Whatever it is. Not that elderberry is not good. Don't get me wrong, we actually use it as a family, but sometimes gets over billed. Indexing is often billed as the solution to all ills of the financial markets, but even indexing has some issues. For instance, if you buy a mid cap index fund, what will inevitably happen is there's drift inside that fund before the index creators reconstitute it every year. Some of the mid cap funds float above over the year, and now they're large cap funds. Or they float below, and now they're small cap investments inside your mid cap fund until they go back and reconstitute.

And then when they go reconstitute, there's additional costs because they announced this week that a company's being added, like Google when it was added to the SMP 500, but immediately after they announced it's



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added what happens to Google? It goes 20% up in anticipation of all the index funds that are required by their charter to buy Google now, and it drives up the cost for the individual securities purchases. And that reconstitution cost could be as little as .8% say in something like the SMP 500, but could be as high as 2% with some of the small cap or small cap value, especially international investments.

We mean that as a type of awareness. Here's the thing. Anybody in index funds, as long as they're appropriately allocated, academically allocated/globally diversified, and we've run some checks, I would much rather have a client in that and managing their own having us give them the larger strategy on their finances than somebody with active management all day. So don't get me wrong, there's just a few inefficiencies in index investing, often referred to as passive investing.

What we're going to talk about today and the things that you can do is what we refer to as passive structured investing. Structured investing is making sure that you have a wide swath of the market with the entire intent to get the market's return, not with the intent of outperforming the market by any significant degree, but gaining the market's return with some small tilts to the portfolio to give you a little bit of extra return. But that little bit of extra return is only designed to be there to pay for the cost of, A, been in the market, and B, having gotten solid coaching.

Cory Shepherd: But here's the big elephant in the room. If you've already got an advisor or an institution that you're working with, it's very likely that they've planted their flag and planted it hard. The value that they provide is either outperforming the market or picking a money manager for you, watching those different money managers and watch ... make sure they're still doing their job right and that they're outperforming the market.

But here's a couple problems. One, if it's a mutual fund, think about mutual fund company. If what they're doing is working and they figured it out, are they ever going to open up a different kind of fund? Would they need to? No.

Paul Adams: They would have the Invest in this Fund, fund.

Cory Shepherd: Yeah, exactly.

Now there's some things about fund size, and it kind of gets cumbersome if there's too many people. You could look up all that kind of academia. But just think about the fact that if they were opening up all kinds of



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different funds all the time, and mutual funds are, then that's just the evidence by itself that they know that they haven't figured out the perfect magic, if they're opening up different funds with different styles, different recipes, trying this new thing.

And then the advisor that's doing it, here's the problem with that. Think about it. You are hiring them to pick the best money manager right now, and they're going to watch and then decide that manager isn't doing their job anymore and switch you to a different one. So you have some kind of continual up, level, down, buy a new one, up, level, down. You're always exiting on a downswing, and you've already experienced the problem before they can jump in and find a solution. Just the evidence that they're always changing or always inventing a new strategy is showing you that they know that they're not working with the secret sauce yet.

Paul Adams: I'll just do this one. Let's use our current political climate. This is where Cory gets super nervous by the way everybody. He's like trying to casually drink a cup of coffee right now, acting like he's not shaking shaking in his boots about what's going to come out of my mouth next.

But let's just take current climate. Pick the politician for them to oppose, okay? And they have come out strong, and for years they've said, "This person's horrible. This person's horrible. This person's horrible." And whether it's a commentator that was super against Obama for eight years or some of the commentators now that every single night the center piece of their newscast is, "Why our current president is awful." Here's the thing. Even if you confronted those folks with massive amounts of academic evidence that they're incorrect about their opinions of somebody, it's not like they can reverse course. They have spent so much time, effort, and energy announcing how horrible the other side is, they couldn't possibly even soften their tone, let alone reverse course.

Well, it's the same thing with money. Let's take a look at a mutual fund company, a great big one, tons of active management like Oppenheimer. And this is not meant like, "Oppenheimer's horrible," or anything like that. We're not admonishing them. This is just capitalism, how it works. Active investing is not going away, just like Los Vegas is not going away. The lottery is not going away. People will still think they are the exception to every bit of academic evidence, and they are going to participate in this speculation and gambling that we refer to as active management.

So don't worry, Oppenheimer's not going to disappear, but here's the thing. Is there any chance, any chance at all that with 2,000 plus



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employees and a total of \$249 billion under management that they are going to reverse course? It doesn't matter how deep the bench is of academic evidence or how many Nobel Prizes are won showing that the efficient market theory works and that stock prices cannot be predicted period.

By the way that doesn't mean, and we've talked about this in other episodes, that your human capital can't be deployed in less efficient markets like real estate. You can learn about real estate. You could certainly outperform the market in that. But that's your human capital being employed that's producing the extra return, not the real estate market.

So, we know they're not going to reverse course. That being the case, we should probably look to academia about what is it they say that's actually going to allow you to outperform the market because we don't see it. And in fact what we do see is that most of the time, and if you're listening on the podcast, I've got a graphic up that shows a 15 year history of active managers and only 17% of them outperformed the market. And by the market I mean the indexes that they voluntarily raised their hands for and said, "I'd like to be compared to that," and then 17% of them beat the index.

That would be a little bit like ... Cory, what's the whole purpose of why somebody would hire an active manager?

Cory Shepherd: To beat the market. To do better-

Paul Adams: To beat the market. Otherwise, I wouldn't need a manager. I would just buy the market. So 17% of them did-

Cory Shepherd: Their job.

Paul Adams: ... their job over 15 years. You had one job! And they didn't do it. I probably shouldn't yell at the mic. I should yell it like this. You had one job! And you couldn't do it.

So, because you had one job and couldn't do it, now we need to look at what would happen otherwise and where does return come from? Is there a predictable return that we can anticipate. In fact, even Morningstar ratings have shown that they can't predict the market, that their returns are random performance even for the five star fund managers over a five year period following, which is why everybody stuck in the financial product sales conversation with you because from their perspective what they have to do is get you to make good decisions and continue to transact with them.



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So we have four areas where the market actually produces what's referred to in economic circles as a premium. Cory, can you walk everybody through the four?

Cory Shepherd: Yep.

Everyone is fairly familiar with stocks versus bonds, I'm sure, if you're listening to this. Stocks tend to do better than bonds, get more rate of return over time. Bonds are less volatile. They don't have as much up and down, not as much rate of return. So that's what you can see in the very top, stocks tend to outperform bonds. So small cap companies, small versus large ... My favorite example of this is Microsoft. Microsoft in the '80s and '90s was a huge growth stock. No one expects Microsoft to do as much growing in leaps and bounds today as it did back then. Part of it is it's already so big, there's not a lot of room for it to grow into the industry. And also it was a much riskier stock to buy way back then. It doesn't seem like it with 20/20 hindsight, but all of us can remember all the other companies that were kind of like Microsoft that aren't around anymore.

Next is value companies outperform. This one's probably the trickiest one of them all, but it's looking at the overall book value of the asset versus the stock price. So what's the company worth when you actually do that internal analysis of everything it has and everything it owns, and then what's the stock price compared to that?

Do you have anything more you want to say about that one?  
It's good for now?

Paul Adams: Nope, but let me do profitability. It's my favorite.

Cory Shepherd: Oh, that was my favorite.

Paul Adams: Okay, you can do this one. I need to drink some more coffee while I brand our Sound Financial Group mug to our YouTube audience. We should have a merch store. Can we launch a merch store, Cory? I think we should.

Cory Shepherd: I'll check with [Fenra 00:13:40], I think so.

Paul Adams: [www.MerchStore.SFGWA.com](http://www.MerchStore.SFGWA.com). Just kidding, we're not ... It probably won't be up by the time this podcast launches, but that was just to make my chief of staff super nervous.



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*“If you look at the chart, even during that time of unreasonable expectation and Pets.com going up like crazy, profitable companies still outperformed unprofitable companies.”*

Cory Shepherd: [Leah's 00:13:55] going to beat that one too.

So this final one is a shocker. Profitable companies tend to outperform unprofitable companies.

Paul Adams: Nobel Prize in economics for Eugene Fama in 2013, in part because of this theory.

Cory Shepherd: To prove that one out, yeah.

But here's what's amazing. In the tech boom in the '90s when tons of companies had revenue but no profit, and their stock prices were going up, and up, and up, that premium is still holding true. If you look at the chart, even during that time of unreasonable expectation and Pets.com going up like crazy, profitable companies still outperformed unprofitable companies.

So it's that simple. There's a lot of other factors, several hundred factors that academics have studied that have some impact on the market, but these are the four that have been proven out as predictable, pervasive, always there, and that we can actually take advantage of profitably, which is important.

Paul Adams: Yeah. We're taking some additional risk. Each of those factors may have some additional volatility, everyone except profitability actually has additional volatility associated with it. But here's the thing to consider. They all have some additional volatility, and yet when it's all said and done, we're getting compensated for that extra volatility, for that extra risk. It's not that we shouldn't have any risks in a portfolio. We should have some, and it needs to be appropriate for you. We go into that deeper in some of our other podcasts. More importantly though, if there's going to be additional risk, we should be compensated for it.

So, you may be in a situation listening to this podcast, and we talk about the white coat window. Highly predictable for people in the medical profession, which is why we call it the white coat window. It's the most easily observable, but it happens for everybody. You at some point in your career go from bumping along making \$100,000 a year, and then your business has a breakout year, and you've suddenly cracked the code of what it takes to make half a million dollars a year. You hit that window. The decisions you make in the next six months to a year after hitting that window are game changing.



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Same thing if you're an executive. Suddenly you've been bumping along with other companies. Your company gets acquired by Amazon, and now your pay scale goes through the roof. Whoever you are and whenever your white coat window happened. Yours may have happened five years ago, and in retrospect as you're listening to the podcast you say to yourself, "Gosh, I wish I would have done a better job with my window." Talk to us. We can help you re-open the window.

But the key is with each of these parts of your portfolio, it's not a matter of you should own just the profitable and not the less profitable companies. This is all just tilt to build into a portfolio, so that you're the greatest amount of likelihood of picking up those little bit of extra returns. That if you can get a portfolio that on average over time outperforms the market by one, one and a half percent, then it compensates you enough for having entered the market and for having coaching associated with that.

Those four factors are ... We use a firm called Dimensional Funds that follows and researches these factors, keeps their costs incredibly low. That's one place you can look. You can look up Dimensional. They've got some great little videos on YouTube that are super educational, and we can put the links to some of those here in the show notes.

Cory Shepherd: It's probably worth mentioning if we bring up Dimensional. They have about \$500 billion of assets under management with about 1,200 employees. So to compare to the other company that we looked at before, \$249 billion, so about half the assets and almost twice the employees.

Paul Adams: Indeed. The difference in work and overhead for actively managed versus passive structured.

Let's just talk about ... So we've talked about part one. Only invest in things that have been academically proven to give you some additional return. But second is we need to rebalance that portfolio. Every year, you need to go in and be able to rebalance your portfolio based upon your original set of investments, so whatever pie you chose originally. We have a pie, we teach our clients, that keeps them in about 12,000 different securities, invested in 42 different countries that are transacting in like 180 countries. That's how we do it. But even if you're doing it on your own, you pick your pie of say your indexes, and you need to rebalance to it every year.





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*“Volatility is what produces the returns. It's not a threat. It's the source of all things good in the market so to speak... You couldn't sell high and buy low if your accounts weren't moving around. That volatility produces those opportunities.”*

Now here's why. It's not because ... Everybody says, "Well, you should buy low, sell high." Of course, but you can't because you don't know when low is.

Cory Shepherd: Yeah, compared to what?

Paul Adams: Yeah, lower than what?

Low only exists in cooperation with high. Meaning if you have ... I'm just going to pick two asset classes. One's small cap. One's large cap to make life easy. If small caps do really well next year, then they are at a high relative to the 2% that large cap did that year. We rebalance. We sell the small cap and buy the large cap, selling at a relative high, buying at a relative low.

Now if you do that with 14 different asset classes like we do in our portfolios, now what happens is you're redistributing the highs to the relative lows, so that you're getting the chance to sell high, buy low, helping you enhance the results of your portfolio over time. And more importantly, if you do not rebalance, you run the risk of a certain part of your portfolio ballooning and putting you in a position where you're taking far more risk than what you may have wanted of. It's a little bit like an artery like ballooning on its edge. And if nothing's done about that, when that part of the artery blows, the entire portfolio takes a significant hit. That's why we want to rebalance every year.

This can be hard when tech stocks are going crazy or you've got Amazon in your portfolio, and it just keeps going up it looks like, and every year you're taking some gains off the table to rebalance. You only wanted a certain percentage in Amazon. Here's the thing. It's hard as all get out, except when it's all done, you've implemented a disciplined portfolio where you can build strategy, hold strategy, and repeat the performance.

Now speaking of holding strategy. Let's talk volatility. How do you think most people just react to volatility?

Cory Shepherd: Volatility equals scary. That's the cultural context for what volatility is. It's the retiree that says, "I can't take this up and down." It's the person who's ... even someone who's in their 30s or 40s, it's like, "I don't want to see my account go down this year." But that volatility is what produces the returns. It's not a threat. It's the source of all things good in the market so to speak. Like rebalancing wouldn't apply if there wasn't volatility. You couldn't



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sell high and buy low if your accounts weren't moving around. That volatility produces those opportunities.

Paul Adams: When I think, a lot of people relate to volatility also like it's a downside phenomenon, but it's not. Volatility is up and down. In fact, I challenge all of you listening. I think you love volatility. I think you love it. When your account is up 15% in a year, you love it. That's upside volatility. But what it comes with is downside volatility, and especially with the kind of run we've had in the market the last few years, we relate to it like it's this ramp going up and as if the returns on a graph are going to be smooth, and up and to the right.

Here's the thing. Why do publicly traded companies ... Why are they willing to compensate us this much for the returns that we're trying to get? Why? Because we're willing to tolerate volatility. If they could consistently, dependably, no matter what's going on with a great deal of security give us 8%, then they would all compete with each other and it would compete down to be like five year CDs paying two and a half, and that would happen really rapidly.

So it's the volatility that is the market announcing to you and I that there are returns in them there hills. Volatility is your friend. Here's the key. You need to make sure you and your family have chosen an amount of volatility that you can remain comfortable with because the most important thing with volatility is that it's structured in a way that gives you the ability to hold strategy through all the volatility. If you can hold strategy, then you can get the returns that are embedded in the volatility.

With that, let's take a quick commercial break. And then we're going to close out and tell you what you can do with what we've taught you today.

Hey everyone. I want to let you know I'm interrupting this podcast for a good reason. If you're someone who's enjoying this podcast, if our philosophy is helping you better think about money, then this offer is for you. We've opened up a financial inquiry call for our listeners of Sound Financial Bites. Our financial inquiry call is 15 minutes where one of our team will ask you some key questions, understand your concerns, and if appropriate, schedule you for a philosophy conversation with myself or Sound Financial Group's president, Cory Shepard. If you email us at [Info@SFGWA.com](mailto:Info@SFGWA.com) with inquiry in the subject, we will reply back to you with a link to our team calendar, so you can schedule a call at a time that's least invasive for you.



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Even if we're not a fit, the team member having the call with you will point you in the direction of resources we have that can help you in whatever the next step for you in your financial journey is.

Now back to your podcast already in progress.

So here's the first thing. All the stuff I'm going to talk about next, you can find at [Nerd.sfgwa.com](http://Nerd.sfgwa.com). I've wanted to use nerd a lot. I love nerds. I am a certain kind of nerd you want on your time. Cory is a nerd you want on your team. Jeff is a nerd that you want on your team. We're just real specialized nerds. But you want to go to [Nerd.sfgwa.com](http://Nerd.sfgwa.com). Put in your email address. We're going to send you all this content. First is we're going to give you a form. And this form is going to give you a big list of questions, total of about 11 questions that you can ask your advisor if you have an advisor right now.

Now that doesn't mean that their answers are going to be comfortable or that you're going to like it, but I want you to think about something. You probably found your existing advisor by accident. You may have made the assessment about whether or not to work with them as to whether or not you could trust them, and you may have made your decision about whether or not to work with them based on how local they were, or they live near you. You may have since moved, and that person's still managing your money. You haven't talked to them in three years.

Here's the thing. If you want, any of you ... If you want to have a conversation with us, we meet you wherever you are. We do everything we do by Zoom Meeting. We want to make sure that you keep your advice with you wherever you go. But you actually for the first time maybe ever be critical, not in a negative way, not critiquing them, but be critical of your choice of what you and your spouse have done for who you would choose as an advisor. It's not an easy decision to make. And it's sometimes even harder once you've made a decision to then go back and realize that you may have made it based upon criteria that you wouldn't have selected again.

In fact by the way, one of the biggest things you'll see out there is how you should choose an advisor is based upon whether you like and trust them. And yet what I would say is that may be the worst possible criteria. You want to have somebody who has demonstrated results, a consistent philosophy, and the ability to continue to educate you in your conversations. If you are in a position where you've had a relationship with your advisor for years, and you've just continued to abdicate decisions to them, and you're not



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getting any smarter about your money, that's a good reason to reassess that relationship. It doesn't mean you've got to work with us, but it may mean it's a good idea for you to just reassess who you're working with.

Next is go run your current investments through a tool called PersonalFund.com. It's a really simple looking website, but it's a great academic tool that will allow you to like X-ray through your existing set of mutual funds whether in your 401K or in a brokerage account with your guy located in a strip mall down the street who happens to give you your current financial advice, and you can see what the real underlying costs of your investments are, [PersonalFund.com](http://PersonalFund.com). It will also be in the show notes.

And then if you want, just get your household on the same page with money. I want to be real clear. If you want to have a philosophy conversation with us ... You're a podcast listener. We want to invest that in you. One of us will take the time to just share what we call our philosophy conversation. That conversation, much like this podcast, is only designed to give you better tools with which you can interact with the financial services industry and with those tools be a more I would say demanding consumer for full situational awareness and transparency with your money. That philosophy talk is no different.

We have a strict rule in our company. No one is allowed to make you an offer in our first meeting, meaning no sales. The entire conversation is centered around teaching you some key concepts that we know you can implement after the conversation whether or not you ever work with us, and then the only opportunity from that call is you could apply to become a client.

So if you are interested in a philosophy conversation and/or application, just email [Info@SFGWA](mailto:Info@SFGWA). Within the title, put philosophy conversation. And our team will get back to you and help coordinate calendars for the least invasive time for you and your family. But just getting you and your spouse hearing the same conversation about the same topic, and then bringing that to new conversations for you as a household will be exceedingly valuable whether or not we ever work together.

So Cory, I think I want to close this out. We'll do our featured podcast review this week. Cory, remind people what they can do if they want to get a copy of one of our books or Michael Michalowicz book in terms of doing a podcast review.



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Cory Shepherd: [info@sfgwa.com](mailto:info@sfgwa.com) is the email. And you want to write your review, get a screenshot, and send it to that address, [info@sfgwa.com](mailto:info@sfgwa.com), along with your preferred form for receiving the book, whether that's physical copy or online.

Can I read this one because it's kind of all about you. It'll sound better if I read it about you versus you saying it, right?

Paul Adams: Totally. I mean I never think about that stuff, but that's why you're here.

Cory Shepherd: Yeah.

So this is actually a Cantonese or a Mandarin character as the name that I can't pronounce. So this is someone from the other side of the world we're reviewing. This is probably the farthest away review we've ever had, which is great.

It says, "If you are a client-"

Paul Adams: How many stars is it? We should make sure we announce that.

Cory Shepherd: Oh yeah, five stars. That's right, five stars.

Paul Adams: I'll be darned.

Cory Shepherd: "If you are a client, Paul adds value to you by analyzing your overall portfolio in a holistic way. If you are a financial service professional in the same industry, Paul adds value to you by his inspiring and educational podcasts and books." So whoever you talked to ... You must have a guess about who this is too. I couldn't have said it better.

Paul Adams: What I love, I have really enjoyed how many financial advisors are starting to follow the podcast, listen to the podcast, and they're taking some of these concepts, which challenge the way they were originally taught, and bring them to bear. I think it's super courageous. This is one of those people that what they're willing to do is cast off the things that the financial institutions that trained them said are the truth, and willing to question that, dig deeper into academia, and challenge their way of thinking. Because what we want to do with this podcast, give you these bite sized pieces of financial knowledge to put you in a better position to care for your future, and it's such a great thing that other advisors are also engaging in that. Because what we



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want for you and for those of you that are advisors who are maybe listening to this podcast what we're after is just helping this information, this knowledge translate to you in a way that helps you be able to design and build a good life.

Announcer: I want to acknowledge you for taking the time to tune into Sound Financial Bites. You stopped long enough in your busy day to reflect on your finances and your future to help you design and build a good life. Please take a moment to subscribe to this podcast and follow us on social media. You can find us on Facebook and LinkedIn. If you have a topic you would like to hear us discuss, please send us a note on Facebook, LinkedIn, SoundFinancialBites.com, or email us at [Info@SFGWA.com](mailto:Info@SFGWA.com).

Be sure to check out the show notes for links to any resources that were covered in each episode. For our full disclose, please check the description of this episode, the description of this podcast series, or you can visit our website.

Make it a great day.



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