Sound Financial Bites 035 - Paul Adams

Episode Transcription

Hello, Paul Adams here. 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.

Hello, and welcome to Sound Financial Bites. This is your host, Paul Adams, president and CEO of Sound Financial Group, and it's great to have you with us today. Today, we're going to have a unique set of conversations over a series of several podcasts. We're going to have what looks to be about a six-part series, but each one's going to be a little more bite-sized than some of our other podcasts.

Why we're going to be doing this is that there's some crucial things that we think people need to know about investing. We've put a bunch of this up on our YouTube channel already, and despite having recorded a webinar where I did this along with, really, doing everything we could to make it a gift to our clients having it out there, it's hard for people to stay engaged for an hour-long YouTube video. So, what we're going to do to support our clients and support all of you that are just curious, out learning, wanting to do better with your money, we are doing everything we can to put together this podcast series. It's going to be about six sessions long. Each one shorter, but putting you in the position where you can make better investing decisions.

"What does it really cost to invest? Are we aware of the costs to investing?"

Now, the series is called, "The Illusions of Investing." Now, why "illusions"? These things are illusions that we're going to talk about, which means that it's something that deceives by producing a false or misleading impression of reality. A false or misleading impression of reality. Now, some of the things we're going to talk about are what happens in the investing world, the kinds of things that people will get exposed to, or better yet, the kinds of information investors are not given could leave you in a spot of being angry, or upset, or thinking about these evil mutual fund companies.

I would encourage you, as we go through this next six-part series, do not go down that path. The reason I don't want you to go down that path is I want you to just think about it as, "What can I do with this new knowledge? What can I do differently with my investing?" or how should my advisor be able to help me more effectively, and not go down the path of making everybody wrong about the way that the investing world works. It's just the way it works. The things we're going to talk about may make you feel objectionable to you, but they are -- I mean, it's just normal. It's all within the laws of the way mutual fund companies run.

So, what I encourage you to do is if you find yourself inside of some of these illusions as we go through this six-part series, just give us a call. Me, specifically, I'm willing to, if my calendar allows for it, I will spend time with you simply because you spent time on this podcast wanting to generate new learning. Second, we have team members that can help you. Regardless of where you are in the country, we do an enormous amount of our client meetings by GoToMeeting, so it doesn't matter where you are, or where we are in terms of you could be across town or you could be in one of the many other states in which we hold all our licenses to take great care of you.

So, we're going to dig in here on the first of these illusions. Now, the first illusion we're going to talk about is stock picking. Maybe I should give you a little bit of a preview of what's coming. You see, we're going to be talking about the idea how does stock picking work? Does track record

investing work? That's illusion number two. Number three is market timing. Can we get in and out of the market, or can anybody? What does it really cost to invest? Are we aware of the costs of investing? And lastly, letting them handle it. Letting somebody else handle the finances. I'm just here along for the ride. Lastly, in part six, we're going to talk about what can you do about it? What can you do to take different action, whether or not you work in our firm, to help you see through some of these illusions.

Now, these illusions, your advisor, in all likelihood, doesn't know about them because I didn't, for years. I was up and coming in our industry. When I was 18 years old is when I got my first licenses, and as I got those licenses, I started getting phone calls, and there was a very nice man who said that he would take me to lunch and teach me about mutual funds. I was, "That's pretty good that we're going to get to go to lunch and I'm going to learn about mutual funds," and because of how I was raised, I reached in my pocket to pay for lunch. When we were done, he'd taught me a lot, and he said, "No, no. I pay for this."

I'll tell you, that, as a young person just starting out in this industry, that seemed amazing to me that somebody was going to go ahead and pay for me to be able to learn and they're buying me lunch. It's great. I said, "When can we do this again?" he says, "Why don't you just try some of these things with your clients and then we'll come back and do it again," I said, "That'd be great." So, I went out and did that. That was a lunch at Denny's, but it wasn't long before after working with some of my clients using some of that company's products that I came back and lunch at Denny's became lunch at P.F. Chang's. That became dinner at P.F. Chang's, became later dinner at an amazing steakhouse, became due diligence trips to other parts of the country where we had a chance to do some really cool and unique things at beautiful resorts all because I needed to "learn" about their investing philosophy.

"Much of the education that occurs for financial advisers comes directly from mutual fund companies."

Now, the fact of the matter is much of the education that occurs for financial advisors, myself included, comes directly from the mutual fund companies. As a result, we end up with a limited view of, perhaps, what's really the most accurate information that we could bring to our clients, and certainly what doesn't come across is the academic knowledge that we're looking for, which is, what would Acadamia say about investing? Because, those are the people who, in this particular set of circumstances are the ones that kind of don't have a vested interest in it. You know, they're not trying to sell a mutual fund, they're not trying to get somebody to buy an investment product. They're just looking at the data for years past, working on a thesis, and saying, "Here's the results."

So, I got into that set of philosophy and that didn't happen until I was in our industry for years and years already. Over half a decade before I, as a part of a separate coaching program, got exposed to a book that really peeled back the layers of the investment industry and made me aware that, "Oh, my gosh. I cannot believe all the things I wasn't told about investing and money," and this was being a professional full-time in the business for years. So, that's what we're going to share with you over this series.

So, the first of our illusions is stock picking. Can there or is there somebody out there who can pick stocks? You see, stock picking is when we hope that there's someone who will be able to pick stocks based upon the belief that they're going to do well in the future. The illusion is that there's investment advisors that can consistently and predictably add some kind of value by picking individual stocks. To really understand what's happening to us when we're looking at investing in

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mutual funds, I think what works best is to go all the way back to World War 2, actually.

Back in World War 2, if you can picture that time of our country, there's much debate about where the war was won and where the foreign powers' war machine was overcome. What many people think about as I've heard people who were high-ranking military, who are clients of our firm, say things and even disagree with one another, "We won it on the Russian front. We won it in the European front," or, "We won it with some of the things we did in Japan." What I want to submit to all of you is none of that's true. That, in fact, we may well have won World War 2 in a little apartment in Harlem.

You see, in Harlem, there was a group of mathematicians that worked for the military in the small codger of really smart people would take data that was sent to them by the generals, and that data that was sent to them by the generals, they would do calculations, they would reflect, they would have conversations, and then send back the results of their calculations to the generals so the generals could, then, make appropriate decisions on the battlefield and in the air power war over Europe.

Well, when there was a set of documents sent to this group of mathematicians, this group of documents showed a scatter graph of where all of the bombers had been hit by heavy aircraft fire and ground fire after dropping their bombs and coming back. They did a whole bunch of calculations about where extra armor needed to go and how much less fuel these bombers would now be able to take, i.e. translate to how much less far are they going to be able to go, how's that going to affect their range, and how much less munitions those bombers are going to be able to carry.

"The brightest minds on Wall Street know they can't out predict the market."

All those calculations were done and getting ready to go out the door, and a mathematician working on another project happened to peek over and see what they were doing and he said, "Stop. We can't send these calculations out," and they said, "Why?" and this gentleman named Abraham Wald, a name many of you have probably never heard of before, said, "Here's the problem. We're studying the wrong bombers." You're studying all the aircraft that made it back after making their bombing run. They successfully delivered their munitions to the enemy and now made it back home. We need to study the aircraft that did not make it back.

Later on, this became an economic philosophy called "survivorship bias" as a way to notice ourselves that when we're trying to make decisions, we tend to only think about those things that are still there. So, now this principle in economics shows us that, just as regular individuals, we will look and say, "Wow, what's working or not working about anything," and we'll say to ourselves, "Well, I think this thing is going to work because look at these people who have done it," but we're not stopping long enough to look at all the people that didn't succeed. We're only looking at the survivors. So, it's this key point called "survivorship bias" as we talk about stock picking and mutual funds that we need to be aware of.

Now, most mutual funds out there are what are called "actively managed mutual funds". These are mutual funds that there is an asset manager who says, "What I'm going to do or what my team is going to do is we will pick stocks for the express purpose of being able to outperform the market and what the market was going to do anyway because we're really smart or we can see where these companies are going or what they're going to do." Now, I want to first talk about

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how unbelievably difficult that would be to do, and then I'm going to show you the data around it, or at least speak to the data since we're on audio today.

So, let's think about how hard that is. If you've had a chance to read a book called, "Flash Boys", this book talks about the idea that there were major Wall Street investors that went through enormous amounts of costs and billions of dollars to be able to lay brand new fiber optic cable so that what they could do is trade faster between the exchanges to be able to make fractions of a penny. Billions and billions of dollars to get that done. Yet, what we're doing, oftentimes, when we engage an asset manager, whether it's the investment advisor that we're working with, or the investment advisor is saying, "We will trust this large asset management company to manage your money," either one of those two, what we're doing is we're saying, "Somebody is going to be able to pick stocks that are going to outperform." But, why is it everyone is so concerned about this little tiny bit of transaction differential? Fractions of a penny. It's because they don't know where the next 20% is going. I think that book, a lot of people got distracted by a lot of other things in the book, but I think what the book makes the best case for is that the brightest minds on Wall Street know that they can't out-predict the market, and here's why. Because everything that we know about a stock's price is already totally baked into its price. It is doing what it's doing because of information that's already in the world. It's like an information translation machine, the price of any particular stock, and what's going to affect that price is new information. New like news. We want to make sure we're taking full advantage of what the market will do without having to think about whether or not, at any particular time, we're picking the right stock in the market.

We'll come back to that when we get to number six in the series talking about how do we solve this. So, let's go back to our stock picking asset manager. So, how have they done? Well, we've had mutual funds since about 1923. It was when the first mutual fund came out. It began the democratization of the individual investor, and as we move through time and we looked at every single year, for many, many years, there were no mutual funds that were ever shut down. Those mutual funds just stayed standing, no problem, and we're off to the races. There's no reason to close them down.

The first major event in the mutual fund world didn't occur until many years in. In 1961, there were only 273 mutual funds and 33 of them were closed in a single year. So, we have this extinction level event that wipes out a lot of mutual funds, and as a result of having those mutual funds wiped out, they got wiped out not because they were doing well. They got wiped out because they were not doing well. As we move further through time, we start to see that, beginning in the 1970s, it becomes a little more regular that mutual funds are getting shut down. But, by 2001, we regularly have over 1,000 mutual funds being closed every single year.

So, let's think about this. If we own a mutual fund company, we have two funds: one doing incredibly well, and one that's not doing well. Which one do we close? Let's say they're both a mid-cap fund, and both of these mid-cap funds have asset management teams, they're doing their best to out-predict the market. One fund went up 10% a year for three years in a row, and the other fund went down 10% a year three years in a row. Well, it doesn't take a genius to figure out which one we're going to close. Because, the one going down in value is harder to market, it's more difficult because we're not going to be making as much in fees on the money because it's gone down.

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If you and I own that mutual fund company together, we're going to close the mutual fund down that did not do well, and we're not going to send the money back to all the investors. What we're going to do instead, what that mutual fund company is going to do is they're going to roll all of those assets into the mutual fund that did better. When they do that, they get to erase, literally, the negative rates of return of the mutual fund that they closed and rolled into the new fund. They get to erase it, meaning if you actually owned that fund and the one that went down 10% three years in a row and it folded into the one that did really well for three years in the row, the bad news is you're going to get your next prospectus and it's actually going to show you the positive rate of return of the mutual fund that went up three years in the row. Now, your mutual fund statement might show you your individual rate of return depending on the type of account you have. But, your actual prospectus you're going to get marketing the fund that you're in will ignore the fact that we had these negative rates of return. You see, over time, the mutual fund companies -- this date is as of the end of 2013: there were 30,500 funds open. Total funds that had been established were 54,000. Meaning the funds that had been closed were 23,000. Almost half of all mutual funds ever opened had been closed or merged in some way by the end of 2013.

Now, I got to tell you -- number one, you should know, this data is not easily available. We literally have had to pay to be part of organizations that get us this academic data. Because, just to be able to subscribe to the services that get this data is a five-figure investment. Like, nobody's knocking on our door telling us this information, because all the research is done, most of it, at University of Chicago Center for Research in Security's Pricing Analysis.

So, what does that mean if we have 23,000 mutual funds that were closed? Well, let's look at the worst 200 of them. The worst 200 mutual funds in that list had a -79% rate of return, meaning that 79% downturn in the mutual fund from the time it was opened until the time it was closed or merged, and when it was closed or merged, it moved into another fund, and the negative rates of return were wiped out for the mutual fund company. So, when a mutual fund company comes out and says, "This amount of our funds have beat their five-year Lipper Average." Well, I'll tell you, another way they could say that is, "The funds that we've allowed to survived have beat their five-year Lipper Average."

So, let's just talk about what the impact is. Well, let's say you start with about $100,000 investments back in 1972. So, now we're going back quite a ways. You start in 1972, you've invested through the end of 2013, and you just bought the S&P 500 Index. You didn't buy anything else. You just bought an index. There's two different indexes. We could look at the S&P 500 or the CRSP Index, which is an index the University of Chicago uses. So, let's just use that as a standard. Both the S&P 500 and the CRSP Index both did about 5 million dollars. A hundred thousand to 5 million, not counting taxes or any fees. Just super easy calculation: 5 million dollars. No asset manager, no pretty brochures, nothing. You just bought one of those two indexes and let it ride, and you had good behavior and you didn't move.

From 1972 to 2013, if you took just the mutual funds that also bought U.S. equities over that period of time, you didn't even go out and try to do any others, you would have had about 2.7 million. So, you would have gone from what could have been a 5 million dollar outcome to 2.7 million. Now, just for a few reasons, we're going to talk about some of them in our later illusions. Some that's fee drag. Much of it is underperformance by active managers. But, if you correct for the survivorship bias we talked about earlier, which the University of Chicago does, you correct for that, and what you find is you don't have near as much money. In fact, you have 2.3 million

dollars less than a portfolio that had no professional management whatsoever.

So, think about that. The wealth lost to somebody that had 100 thousand dollars in 1972 through 2013 is more than what most families are going to actually have to retire that 2.3 million. It could have been 5 without needing to flip real estate, without needing to successfully sell the business one day, if you're a business owner, without enormous stock options, without all the fancy stuff that people hope is going to turn out their future. Literally just holding a disciplined strategy would have gotten to 5 million and guessing and hoping the average active manager, if you just took their actual performance over time and you corrected for the survivorship bias -- because if you bought every mutual fund that's been in existence since 1972 that's still open today, you're going to have much higher results. Why? Because we would only be looking at the survivors and not most of the fund that people actually invested in.

The hardest part about this is, and what we're going to talk about next time is track record. So, let's just talk about our next podcast coming up. What's very easy for us to think about is that, "Well, Paul, I know. You're talking about the average active asset manager. I get it." But, I'm not going to get the average active manager. I'm going to get an above average active asset manager. I'm going to get the above average mutual fund. In fact, my investment advisor told me, or the Money Magazine that I read, or the blog that I read online all pointed me to the fact that one of the things I needed to do is look at somebody's track record before investing with them. That, too, is an illusion that requires examination and we'll be doing that in our upcoming episode.

We look forward to hearing for you. Don't hesitate to reach out to us if any of these podcasts in the six part series brings some grinding questions to you or your spouse. I would be happy to spend some time with you about it all. See you on Episode 2.

Hi, Paul Adams here. I want to acknowledge you for taking the time to invest in yourself by listening to our podcast. Not everybody does that. And out of my commitment to you, I will take just a few of our podcast listeners between each of our episodes and spend time with them one-on-one. If you think you'd like some of that one-on-one time to learn more about our process, our philosophy, or whether or not we'd be a fit to work together, just email info@sfgwa.com. That's info@sfgwa.com, and I'll be more than honored to take that time with you. You can also go to our website, www.sfgwa.com, download the first three chapters of my book, see upcoming in person events that we have, or listen to past episodes. You can also go to our Facebook page and engage us there, our LinkedIn, and send us questions for upcoming podcasts. You might hear one of your comments or questions on that future podcast. And for our full disclosure, you can check the description on this podcast or on the podcast series, or go to our website. Have a great day.

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