



Sound Financial Bites 036- Track Record Investing Episode Transcription

"It's impossible for an asset manager to successfully and consistently pick stocks that will outperform the market."

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. My name is Paul Adams, CEO and president of Sound Financial Group, as well as your host for today's episode. Today's episode is part two of a six-part series on "The Illusions of Investing". Why we're exposing some of these illusions of investing is we know it's a lot to invest and dig into a one-hour YouTube video, although it's gotten a lot of views as we pulled out a lot of the knowledge we're going to talk about on today's podcast. What we've noticed is it's a lot easier for people to do on the fly.

In support of our clients, what we're going to do is just take everything from the illusions of investing talk that we've done in many of our clients' events and break it into these individual podcasts so we can connect with you with knowledge right where you are as a part of your daily life so that you can design and build a good life. You can put yourself and your family in a position where you're going to be able to have the amount of capital and assets required for you to have the good life that you want to build.

Let's talk about illusion number 2: track record investing. In our last episode, we talked about the idea of stock picking that when you hire an active asset manager, they're hoping that they can pick stocks. In fact, they're -- I don't want to go as far as they're promising they can pick stocks, but they certainly lead people under the impression that, with their unique knowledge, they're going to be able to outperform or do something else unique with the knowledge that they have so that you're willing to invest money in their mutual funds.

In our last episode, we talked about how it's incredibly unlikely that these asset managers are actually going to be able to produce the outcomes that they hoped that they could produce based upon actual historical data of how mutual funds have done when we correct for this idea of survivorship bias. Today, what's easy to do is to say, "Well, Paul. I'm just not going to buy the mutual funds that didn't do well. I'm going to buy the mutual funds that did well." Effectively saying, "What I'm going to do is I'm going to rely on the investment managers or the mutual fund's track record to be why I'm going to invest."

Let's think about it. I'm going to rely on my track record. Now, that makes sense in every other way. If we were trying to bet on a baseball game, that might make sense. If the Yankees have done really well in every season in the past, we might be able to anticipate they're going to do well in this season. Like that, all of that stuff is quite likely that track record's an appropriate way to make a decision. It's not so much a great way to make a decision when we're looking at asset managers. Here's why. We talked a little bit last time about how unbelievably difficult - and by difficult, I might go as far as "impossible" it would be - for an asset manager to successfully and consistently pick stocks that are going to outperform what the market would have done anyway. But, let's take, for a moment and say, "Okay, let's say somebody did do it." Over summarizing the time, they did outperform the market, and a result of outperforming the market, we bet on them. Is it likely they're going to be able to do it in a future period of time? Well, there's some great studies that have been done out there, mostly out of the academic record. We're going to take an example if we just took a basket of mutual funds, of 3,000 different mutual funds and we started



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"38% of mutual funds, a little better than 1/3 of them, actually outperformed the S&P 500."

at the beginning of 2007 and we go through the end of 2009, so a total of a 3-year period. And we just analyze the performance of these 3,000 mutual funds largely investing in the U.S. stock markets. So, it's just U.S. large cap funds, very specific segment. How did they do? Well, 38% of them. So, a little better than one third of them actually outperformed the index that they were being compared to. In this case, the S&P500. Though, let's say we just took that 38% now, and now only analyze the winners for the following four years. How did they do? Well, then about 25% of them over the following four years actually outperformed the relevant index. So, wait a second? You mean I took only the approximately one third of investment managers or mutual funds that outperformed the market and then I invested in those over the following four years, and of them, only one in four did? Yes, that's exactly what I'm saying. Some of them, by the way, were closed. At the end of that period, they might not even be in the study anymore, okay?

Let's look over a longer period of time: 2005 to the end of 2009. So, now we have a five-year period. Of that five-year period, we have about 3,000 mutual funds in this study again. 28%. So, now less than a third outperformed their index. Another way to say that would be less than a third did their job because their job was to outperform the index. That's why we invested in them. So, 28% out from the index. Now, we just take that 28% and look at them only over the following four years and 26%. So, about a quarter of them outperform -- wait, we just watched all these mutual funds for five years. About a quarter of them did well, outperformed their index, and then over the following four years, only a quarter of them outperformed -- it's almost as if it's unpredictable.

Let's look at another period of time. Let's say we analyzed these same mutual funds over 10 years. Now, 25% of the mutual funds studied over 10 years outperformed their index, and yet, afterward, we only look at the next four years: 2010 through 2014. Only 28% outperformed their index that they were being compared to. So, think about that. We have no idea, because if we were trying to make this analysis back at the beginning of year 2000, and we were trying to pick all the mutual funds that were out there, we would then need to, one, pick ones that were going to survive the first 10 years. Because, that's kind of the nice thing about this study is they're actually giving the benefit of the doubt that we're studying the ones that survived the first 10 years. There was a larger mutual fund universe to start picking from at the beginning of this study, but they narrowed it down with hindsight to only the ones that survived.

I just want you to think about this for a moment. Literally, the mutual fund list would have been longer. So, if you were lucky enough to only pick the ones that were going to end up surviving, then of those, you'd be in the position that only a quarter of them would outperform. That's the problem. That's the problem with when we're trying to pick these investment managers based upon their track record. Now, without going into it for the podcast's sake, I want to share with you that the numbers are worse - they're worse if it's a bond-based mutual fund.

An exercise we do at one of our live events is that we actually give every participant in the room a quarter, and as we give everybody participating in the room a quarter and have them all stand up, what we do is we pretend that we're a mutual fund company. Given that any active manager has about a 50% chance of outperforming the market in any particular year, what we do is just pretend that everybody in the room is an active manager flipping the coin every year. To get heads means you outperform the market. To get tails means you didn't outperform the market. Why this is such an interesting concept is that this is not too dissimilar to what mutual funds actually do. They will literally start mutual funds - fully filed and functional mutual funds - with



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"Past performances no guarantee of future results."

money in them but they don't market them yet. Because, you'll notice nobody's ever marketed a mutual fund to you that didn't have at least a year's worth of or a few years' worth of track record. They seed a lot of these mutual funds, they put mutual fund managers in charge of them, and as a result of putting the mutual fund managers in charge, they now compete them against one another to see who's going to do better to beat their indexes.

In our room, we have people begin flipping coins. Now, if you flip a coin and you get tails, you have to sit down and you have to hand your coin to somebody who's still standing. And we go through year one, year two, year three, and by the end of year four, there's a handful of people still standing. The record we've had at one of our events was one person flipping heads 16 times in a row. This woman, who's about 67 years old, hit it 16 times in a row and, literally, people are cheering, and everybody's kind of enjoying this. But, the funny thing is that we all know it's random chance.

Now, at the end, she has all the quarters in one place. All the quarters rolled up to her as each asset manager had to give their assets away to somebody else. But, it's not that much different in the mutual fund world that they can, because of survivorship bias, because they closed down the mutual funds that don't do well, there's also a large influx of capital to mutual funds that do well, partially because the investors are sending in more money, and because, inevitably, smaller mutual funds that don't do well get collapsed in a large mutual fund that is doing well.

When people begin to understand that, we start to understand why, at the bottom of every statement, it's required, by law, that it say, "Past performance is no guarantee of future results," and the reason it's there is because it's true. It's true not just from a legalistic perspective that mutual fund companies and asset management firms have to put it on documents, but it's also true meaning you can't look at mutual fund managers and say, "Hey, this one did well, so they will do some degree of well in the future." It's not that somebody won't do well. In fact, I promise you, somebody will do well. We might end up with a review on the podcast that says something to that effect. "Oh, this guy did really well and for this many years."

There will always be somebody that does well. There will always be the person that flips heads 16 times in a row in a large enough sampling of people. There's been 52,000 mutual funds as of the end of 2013. There's going to be that Fidelity Magellan Fund that just did incredibly well for many, many, many years. Those funds exist. The only thing is when we go backward in time, we had no way to predict who was going to be that amazing mutual fund that produced amazing results for so many years. We just could not have guessed it ahead of time. So that we can't rely, it's an illusion that we could rely on track record as a part of what we would do.

Now, in today's trying times, it seems like we're always in a trying time around money, and finance, and somebody saying the stock market is going to collapse or the U.S. is not going to do well. All that stuff's always out there. In our next podcast, part three of this series, we're going to talk about market timing, and can you or I put ourselves in the position, or can some investment manager put themselves in the position to consistently get out of the market when it's not working and get back in when it is working. I look forward to seeing you on part three of the series and we're glad to have you with us so far.

Hi, Paul Adams here. I want to acknowledge for taking the time to invest in yourself by listening



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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. And 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. Now, 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 a 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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Data is from the Survivor Bias Free Mutual Fund Database created by the Center for Research in Security Prices (CRSP) as of 12/31/13.

2016-28421 Exp 9/18

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