Sound Financial Bites 038 - Paul Adams

Episode Transcription

> *"We're hoping we can make it up on volume when this trading happens, but it just doesn't work that way."*

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, President and CEO of Sound Financial Group and your host of the podcast today. I'm excited because we're now in part four of a six-part series on the illusions of investing. This is a talk we often give to our public events where we invite our clients in and the people that they care about to be able to share financial knowledge that they're otherwise just not going to easily get in the marketplace, things that kind of tell some of the little secrets in our industry, and how our clients can better navigate around them, and the people in their lives that they care about can better navigate around those things that are difficult in the financial market.

What we want to be able to do is support you and support the people around you to make better financial decisions not because it's about having this much better rate of return or it's about having this much more money, but all of it is there so that we can design and build a good life. You see, without having the mission of designing and building a good life for you and your family, all this financial stuff is for naught. So, I want to acknowledge you for taking the time to tune in to learn about all of this, and we're going to dig in here to part four after we do a brief review of what we've covered so far.

So, episode 1, part 1 of this, was the idea of the fact that we can't stock pick, neither can the asset managers. We laid out a clear case for that. Second is even the asset managers, or the stock pickers, or even ourselves, if we're the ones stock picking and trying the market time, even if it worked out well in the past, it's not likely it's going to repeat in the future. Or if it does, we will not be able to predict ahead of time who's going to do well in the future. Then, third, what's the idea of market timing? Well, gosh, if I can't pick stocks or I can't find somebody who's going to pick stocks and I can't even find them based upon their track record, then maybe I should just watch what's going on in the world and try to get in and out at the right time, and that's not an effective strategy either.

So, now people sit back and say, "Okay well, what should I do? You know, I guess I'll just throw it all into a regular mutual fund, hope that this asset manager knows what they're doing, they've done pretty well in the past, and at least it doesn't cost me that much." Now, that's pretty normal, and people don't realize the fees that are incurred as an investor when you're trying to own stocks or even mutual funds. The illusion is that if you don't see it, it can't hurt you, but it does hurt you. We're going to talk about that.

I'm going to give you something real easy to do. If you're driving right now as you're listening to the podcast, don't do this right now, but maybe do it when you get back to your office. I want you to go into Google, and I want you to Google "real cost of mutual funds". "Real cost of mutual funds." Now, this you're going to see, I think it's still one of the top ranked articles. You're going to see an article from Forbes of 2011. Now, we're going to pause here real quick. You don't see a lot of content pushed on this topic. There's two reasons why.

One of the biggest is you'll see Forbes or other magazines rarely write about it, because who's their advertisers? Tons of mutual fund companies. The mutual fund companies are not excited about lots of investors understanding these things, because as more and more people have understood it, it's hurting the profit margins more and more of these mutual fund companies. So, that's the number one. Number two, you won't see a lot of it because the types of content that gets pushed to the top of Google are financial institutions that have done SEO, etcetera. So, there are not people who are wanting to spend money to push the narrative of how much mutual

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funds are really costing people.

So, let's talk about what it takes and what it's costing. You read through that article, you're going to see near the bottom, it's going to just give you an example of a non-taxable account versus a taxable account, and that there might be an expense ratio in the fund. Now, I'm just picking the average expense ratio they talk about in the mutual fund, and a .9%, which seems not terrible to most people. They say, "Well, it's less than 1%," and the fact that it's less than 1% doesn't speak to the fact that there are other costs inside the mutual fund.

So, let's talk about those other costs. They have transaction costs, and this is every time they buy and sell a mutual fund, they have to pay for the transaction, because they've got to pay somebody to trade these stocks. They pay a blend of a market maker, etcetera, and then there's another thing called "cash drag". You see, when we're in most mutual funds, we are locked arms right and left with an undisciplined investor, and because we're locked arms in a strategy with people that we don't know who are likely undisciplined investors, those people are going to move their money in and out probably when they shouldn't, and when that happens and those people move their money in and out, it costs us money not because of them moving their money in and out, although there's some component of that, but because the whole mutual fund has to leave a lot of money in cash. As a result, the money they leave in cash costs another, on average, .83% rate of return.

"These asset managers are hoping to make it up on volume, but it just doesn't work."

Now, if it's a taxable account, we may also be paying taxes we're not realizing that accumulate another 1%. So, a non-taxable account, meaning it's in a retirement fund, etcetera, we might only think it's a .9% rate of return, or a .9% expense ratio, but all in all these expenses in one fund of 3% or more, and if it's a taxable account, maybe it's 4% a year. Now, let's put that into perspective. If we're hoping the market does 10% a year over time, then that could be costing us 30 to 40 percent of our entire rate of return every year. That's almost like being a NFL football player and having an agent taking a cut of everything we do, and yet the company, what they're doing, is they're just sending us mutual fund statements. They're sending us market updates. They're frankly also sending us, if you watch any of these mutual fund companies, they're also sending you a great deal of additional marketing material, and all of that are expenses that are being supported by these both disclosed and undisclosed costs that is a part of our mutual fund. You can read more about it when you go to "real costs of mutual funds". I think the first one's still Forbes, but there's going to be others that you can read through on there, other articles that will kind of get your attention.

Now, why does this happen? Well, to start with, it's because, first, there's all these transaction costs that these fund managers have to be in every time they trade a stock. Now, why do they trade stocks so much? Well, their job is to beat the market. Now, we talked earlier it's unlikely that any asset manager is going to be able to consistently and predictably outperform the market, but they're all trying, and you can't just not do anything and say, "I'm going to outperform the market." What the marketplace expects these asset managers do is to roll the money around.

So, I'm reminded of a joke of these two fairly uneducated guys that were brothers, grew up on a farm, and what they did is they would often -- they raised other types of crops, but kind of during a certain part of the summer, what they would do is go to a friend's farm, buy tomatoes, take those tomatoes, and go sell them at market. They've been doing this for years ever since they were teenagers. Now, they're in their 20s, and one of the brothers said, "Well, I'm going to go and I'm going to get some education." So, he goes to community college and he takes a marketing class. He goes and takes that marketing class and he says, "I've got a great idea." He said, "What are we going to do?" He says, "Next week, we're going to go buy those same tomatoes for a dollar, and instead of selling them for $2 each, we're going to buy twice as many tomatoes, and we're going to sell them for $1.75 each, and it's brilliant. There's this thing I learned about that's part of marketing and economics called "supply and demand", so we're

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going to just drop down the price of the tomatoes, we're going to buy more tomatoes, and we're going to make it up on volume." His brother says, "Are you sure." He says, "I'm sure." So, they go and do it. Sure enough, they sell all the tomatoes, more than they've ever sold before. So, they go back the next weekend and they go back to this ranch, they buy all these tomatoes for $1 each, and he says, "What are we going to do now?" "We are going to buy twice as many again," so now four times the amount of tomatoes. He says, "Are you sure?" He says, "Oh, yeah." So, they go back to the market and, sure enough, they sell them all. They sell them all for $1.50, and it's brilliant, and the brother is blown away. He says, "This is great. I'm going to have to go take community college next year. This is phenomenal," he says, "we're going to do it again?" "Oh yeah, we're going to do it again." So, they go back. Now, they buy eight times the amount of tomatoes, the shocks on the back of their pickup truck are totally pressed down, and off they go to the market, and he says, "What are we going to do today?" He says, "We're going to sell these tomatoes for 95 cents each." He says, "Well, how are we going to make any money?" He says, "We're going to make it up on volume, brother."

The problem is we're hoping that we can make it up on volume when this trading happens or that these asset managers are going to outperform the market. It just doesn't work that way. In fact, all the studies point to the fact that it works exactly the opposite. Remember earlier when I spoke about how often the active managers actually beat the market? Well, if you study all mutual funds, then you look at how likely, as a percentage, those mutual funds were to either keep up with the index they're being compared to or outperform it, it is totally correlated to how much the mutual fund turns over. And the turnover is how often the trades occur, and does the entire asset base effectively get traded all year, and the higher the trading that occurs, the turnover that occurs in the mutual fund, the less likely they are to outperform the market.

"We need to know what we're paying and what we're getting for in return."

So, these asset managers are hoping to make it up on volume but it just doesn't work. So, there is a guy named Charles Ellis. He is an industry legend, owns a huge company that consults with large, large, large financial institutions on their own investments, and in his book, he wrote a little bit about this idea of how active managers are doing. Now, his book was called "Winning the Loser's Game", and his quote was, "The key question of the new rules of this game is, 'How much better must an active manager be to at least recover the costs of active management?'" and frankly, the answer is daunting. Well, his quote is, "The answer is daunting." Frankly, I say, it's daunting.

So, what we have to think about is this cost of investing, we actually need to look at the cost, we need to understand, we need to know what we're paying, and what we're paying for, and what we're getting in return, and we need to know what we're paying for that we're being told about, and more importantly, we need to be told what we're paying for that we're not being told about. It's not uncommon that when we end up running an analysis and looking at somebody's portfolio that aside from the disclosed cost, all the things they know they're paying an investment advisor, or they're paying the mutual fund fees that they're in that when we dig in and show them what those generally undisclosed costs really look like that are causing the rate of return drag on their investments, people are shocked, and oftentimes wanting to move their money to an account. Oftentimes, if we're the ones doing the analysis, they're having us do it, but an account that creates a much greater degree of transparency so that we're passing through as much as we can back to the client.

So, if as you're hearing that and the cost of investing is just really ringing true for you and you just have no idea whether your IRAs and all that really have the low cost alternatives in it, and whether you're benefiting from it, you can just reach out to us. We'll be happy to take the time with you and have enough conversation with you to know what should be recommended. But, I'll even take the time to just have that conversation with you if you're taking the time to invest in yourself with these podcasts.

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So, that wraps us up. That's part 4, illusion number 4, that the cost of investing may be larger than what we know, and I look forward to seeing you on part 5. Now, part 5 is going to be an interesting one. This is all about this idea that what most people do with their financial decisions is totally abdicate, and I promise you you're going to have people in your life, probably, that you should send this episode to, but you're probably going to be texting the next episode to a lot of people that you care about who may have been on this path, or husband and wife may not be on the same page, or you might be the one making all the financial decisions in your house, and you're going to need to send this next episode to your spouse so they can hear it and they can step up to the plate to make better financial decisions, or at least participate in the decisions being made for your household. I look forward to seeing you on part 5.

Hi, Paul Adams here. I want to acknowledge 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. 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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