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Episode 151 - Is The Sky Falling? The Market Reaches Another New High, Part 1

Episode Transcription

"If you are not paying for the service, you are the service."

Paul Adams: Hello and welcome to Your Business Your Wealth. My name is Paul Adams, founder and CEO of Sound Financial Group. And once again, it's been months since last time this has happened, I have been left with zero supervision. Cory is out of town on vacation. Jeff is out of town on vacation. Here I am, me, Jordan our video engineer, and we are going to hopefully not go off the rails, I'll be able to focus, but most importantly I get to spend time with all of you. Now, before we jump into today's episode in detail, let me give it to you high level. Is the sky falling? What do we do when the market reaches new highs and puts us in a position where it's kind of going around whether it's the news or our friends and we start to look for this could be signs of the slow down, etcetera. And this is gonna require a little bit more work than our normal episodes, so we are gonna have two episodes. I promise them to be entertaining. And I'll tell you what, if I don't keep it entertaining, then you can have your money back for everything you paid for this episode. I hope that's fair. But let's talk a little bit about things that are in the news because everybody knows I like to see what's going on out in the financial current and give you all a bit of a taste of it.

Paul Adams: So let's... We're gonna jump in and look, this happens to be The Seattle Times today, and it's from July 27th. So just this last week by Chuck Jaffe. Now here's the funny thing about this article. We read all kinds of things. People come out with all this media about this new app, that new app, what you can do with your money. And one thing I really like is that what Chuck Jaffe covers in this is, one, he talks about the fact do not just sit there and look at every new app or the ups and downs in the market because you're gonna drive yourself bananas. And I'll speak a little bit too what we're gonna cover in today's podcast. But this is the key of this article, is that we all hear about this app called Robinhood where you can trade stocks and it doesn't cost you anything. And that seems like it would be a really good idea. But what we're gonna do is scroll down in this article 'cause I wanna point out one specific thing: While Robinhood has created appropriately, and effectively, downward pressure on all trading platforms in terms of individual cost, how they're paying for it may not be so clear. One way to think about it is, that he puts in the article, if you are not paying for a service, you are the service.

Paul Adams: Now the question is, who are you serving? And he speaks to that, is even though Robinhood is now valued at billions and billions of dollars, etcetera, Robinhood does this. I'm gonna read directly from the article, "There's also something called payment for order flow where brokerages or a brokerage gets paid for directing orders to different parties that execute the deals. The brokerage firm receives a small payment often a penny per share as compensation for putting the trades in certain directions. Robinhood in a statement that came out last year quoted its payment for order flow revenues at 2.6 US cents for every $100 traded rather than quoting a traditional price based on each share traded." So it makes it hard to know if Robinhood is making more or less than other brokerage firms. Some detractors have said it's much higher than the norm. Now, regulars are working on trying to eliminate some of this payment for trades

and to really squash down some of the things that really create costs, whether that's potentially cost inside Robinhood or costs inside major mutual fund companies that are not fully disclosed. Again, regulars are working on it but this is the key, the point for the customer at Robinhood is that professionals are lining up for the right to trade against you.

Paul Adams: Meaning there's all kinds of professional traders, market makers of some sort, that are lining up to handle the trades when you wanna buy something or you wanna sell something. You think about this very simply, any time you buy or sell a stock there's someone on the other side of the transaction who disagrees with you. Very simple. I wanna sell a stock somebody else is willing to buy it. I am selling it because either it could be life circumstances or why I wanna sell it or it might be I think it's gonna go down. Most of the time people are not trading for the life circumstances, they're trading for the potential gain. And when they do that it creates this environment where you're competing against a trader who may be way better educated than you are, who does it full-time, who has unbelievable amounts of computing power behind them and research departments, and they are on the other side of that trading transaction with you. And he makes a very cute metaphor, as a trader you wanna trade against people who aren't informed and you want to avoid traders who are the most knowledgeable.

"We are not rational beings, we are emotional beings who rationalize our actions after the fact."

Paul Adams: That's not what you get when you trade on an app like this. But this would be like The NFL saying it wants to save money printing its playbooks, and learning it can get those costs reduced to zero. All they have to do is use a printer run by say the opposing team, in this case he uses the New England Patriots, a team that it's scheduled to play. Well it'd be great to save all the money on your playbook, but it may not be worth it when it shows up to game time. It might feel great to simply reduce cost but if that reduction in cost is putting you in a position that you're trading against the very best people out there and maybe not getting the trade execution the way you'd like it, etcetera, I don't know what all the downsides could be.

Paul Adams: We would obviously say it's important to have a coach or advisor there, and it's impossible to create an academically allocated globally-diversified portfolio or nearly impossible for it to have 13,000 different positions and rebalance and screen when companies go from being a small cap up to a large cap, and do you get them out of the portfolio? All the things that have to go into true portfolio management are not likely to be able to be done on a phone app with your thumbs for zero cost trading. Okay, so that's it for this week in the news. We wanna watch for those kind of things periodically, give you some unique things to think and talk about. We'll put a link to that inside the show notes. If you wanna forward it to a friend who's using Robinhood, that might give them a little bit of a start of "Uh, maybe I should rethink this." It's a great thing to point them to. So let's get back to our first part of this two-part episode series on the Sky is Falling. Now, people don't say the sky is falling. What they do is they'll say something very intellectual.

Paul Adams: "You know the market is in a whole new high, and it's just doing really well, and I think it may be about time for a market pullback or a recession." Or you'll hear words like "leading indicator". All kinds of things begin to come up and it kind of enters into the ethos of, "I think the market's gonna go down soon." And when people start to talk that way it creates an opportunity for people to now begin to fear potential losses more than they should fear the missing out on gains. So we're gonna cover a little bit of that today, touch on a little bit of the research in this episode but then go deep into the research in the next episode, again guaranteed, absolutely, stone called guaranteed to be entertaining.

"It is important to know why we did it, because we could be in a position that if we don't realize we're going to rationalize it, it could throw us off."

Paul Adams: Let's jump right to just looking at the fact that we're pattern recognition machines. If you look at any one of us and we go back to our ancestors, what happened? With our ancestors they had to recognize patterns: Patterns of seasons, when things would grow, when it was time to harvest, when the wild animals that were large enough for us to sustain a family off of would move through the areas so that we could intercept them and hunt. Those are all things super important about pattern recognition, and everybody who wasn't any good at pattern recognition has died, many, many, many generations ago, their genes are not likely in the pool and it's available to have made you up. You have pattern recognition deep inside your bones. But the problem is that it's so deep inside of us, this pattern recognition, we will tend to find patterns that may not actually exist.

Paul Adams: You see, Scott Adams talked about in our episode 147, if you haven't listened I wanna highly encourage you to go back to it. He talked about the fact that we're not rational beings, although people would like to think that we are. We are emotional beings who rationalize our actions after the fact, which is often the case even with our investing. You see, when somebody makes a move in the market, "I got out of the market, I got into the market, I bought this stock," whatever they said and then they make up the reason why. Because if you said I felt it in my bones, people would go, "That's kind of weird I'm not gonna listen to your investment advice." So what do we do? We construct all the reasons why we did something for better or worse. Or even those things that lose us money, we will come up with the reasons why we did them.

Paul Adams: It's important to know why we did it because we could be in a position that if we don't realize we're gonna rationalize it, it could throw us off and have us too often make a change to our investments in our portfolio. You see, the biggest problem in understanding our ability to predict is this idea of something called hindsight bias. Now, I wanna read this to you guys directly, this is straight out of Wikipedia, to give you just the definition of hindsight bias and what's gonna happen is, we will do something or something happens in society or in our case we're talking about the stock market, something happens to the stock market and then after everything has happened we look back and go, oh, that was this thing and then we have all this explanation for it, you'll even hear people's explanation of it with the way that it's, the past tense or future tense

when they're talking about it, they literally, they talk about it as if you could have seen it at the time. Now, maybe some people did, but did, everybody didn't and as a result it messes us up in how predictable we think the future might be.

Paul Adams: So hindsight bias also known as the knew it all along phenomenon or creeping determinism, refers to a common tendency for people to perceive events that have already occurred as having been more predictable than they actually were before the events took place, a result people often believe after the event has occurred that they would have predicted or perhaps would have known with a high degree of certainty that the outcome of the event would have been what the outcome of the event would have been before the event occurred. Hindsight bias may cause distortions of our memories and what we knew and or believed before an event occurred. I'll stop right there, I wanna re-read that.

"Hindsight bias also known as the knew-it-all-along phenomenon or creeping determinism."

Paul Adams: Hindsight bias may cause distortions of our memories of what we knew and or believed before the event. For instance, you may have been a real estate investor in 2006, saying, "This is going up, everything's going well, I see it coming, we're going to the moon, it's like I'm gonna be worth $20-30 million, I just need like five more years of it to go this way," that's how you might have actually been feeling at the time. After 2008, we recast and even can create false memories. Hypnosis, people who study hypnosis know this all too well that you could then look back and say, yeah, I remember in 2006, I was looking at the rise of real estate prices, and I couldn't figure out why it would be this affordable anymore. And I knew that I should get out but I still saw the... And you just recast the entire experience which then leaves you with false information upon which to make your decisions going forward.

Paul Adams: Now, if this doesn't feel a little bit like mentally when you really get in a hindsight bias, that mentally you feel like a sock that's been turned inside out, [chuckle] when you think about the past and the future... People do this with the relationships all the time. Everything was going well, everything was good, this person was a business partner or a friend or something else, and we never saw anything coming, then after the big blow up and everything goes bad and the business breaks up or the divorce or whatever then we look back and we go, "Oh yeah, I should have seen this, this, this, this, this." Or then you get far enough down the road you act like you did see it. We just need to be aware these are all things called hindsight bias, and this is a significant source of overconfidence regarding our ability to predict the outcomes of future events.

Paul Adams: Examples of hindsight bias can be seen in the writings of historians describing outcomes of battles, physicians recalling clinical trials, and in judicial systems as individuals attribute responsibility on the basis of supposed predictability of accidents. You see, we just have to be super aware of how hindsight bias has the ability to affect us and how we might view things going forward because otherwise we're going to look... We look at, say, 2008, we're like, "See how high that was? This market is at a whole new high,

higher than it's ever been before. It could be another 2008." Now, we keep thinking it's going to be another 2008. Why? Because most people whose investing lifetimes have lasted longer than 11 years where we are now, or even if it was before they're investing lifetime but they remember the emotional fall out of all that, they will think that they can predict the next one. It's a little bit deceptive. We call hindsight bias but it really affects our capacity to predict the future and how confident we are, and often gives us a tremendous amount of hubris about the way we're gonna be able to predict what's coming next.

Paul Adams: Alright, well that's a quick break so you can hear a little more about how to engage us here at Sound Financial Group, we'll see you right after this message.

"Hindsight bias may cause distortion of our memories and what we knew and or believe before an event occurred."

[music]

Paul Adams: Hey everybody I had to interrupt our show for just a moment to share with you something new. We've designed a new white paper that we think is gonna add new value in the way that you think about money. It's three of the biggest mistakes we see people make and six ways to fix them. Now, for some of you, you might not want the white paper. You might be ready to have a conversation with us and that is okay. You can email us at info@sfgwa.com, that's info@sfgwa.com. Find us on the web at yourbusinessyourwealth.com. And any time on any of our social media platforms, send us a message and we can get you this white paper. But in the meanwhile, if you want to just skip over the white paper, have a philosophy conversation with us, we're happy to do that with you. Just let us know, philosophy conversation, the subject line. And if you want this white paper just put white paper in there, and we'll immediately get out to you, this white paper on the three biggest mistakes that we see people make, and the six things that you can do to fix them. And now back to our show.

[music]

Paul Adams: Welcome back. Let's take a look of what somebody's actually saying when they say, "Well, the market's really high right now." They're implying that that means the market could take a dump pretty fast. Meaning it's gonna go up, up, up and then it's gonna go down. And it's gonna go down bad. And it might affect your future plans, etcetera. Here's the thing, it might be and it also is not likely to be, purely statistically. We're gonna get to that in a minute. But when we believe that something's going to happen, we're likely to behave badly. You see, there are times that we act on our hunches and sometimes it works out. I wanna offer to you one of the worst things that could happen is that you're right. You see if you're right about speculating and gambling with your money, which is all it is, meaning there's no academic evidence that anybody can consistently or predictably, figure out what the market's going to do, which means when we say we think it's high, and we're gonna pull our money out, or we're gonna leave our money on the sidelines, we're not gonna be consistently investing. All we're doing is some

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version of speculating and gambling. And what happens when you speculate and gamble, what do the casinos do?

Paul Adams: They want you to have some wins early. Because if you have some wins early, you're then going to be further and deeper into the game. And if you wanna get a sense of what that's like, just look at any of the online trading platforms if you see them advertised in your browsers at all, what are you gonna notice? Their advertising is not that much different than the online casinos. And there's been some studies on this, I had a chance to be at an event one time where they literally registered people for online trading accounts, at the same time they registered for an online casino and then they compared every one of the emails that came in and it was astounding the similarity. So when people are saying this, they say the market is high. Here's the question: What market are they talking about? Now, we've covered this in one of our prior episodes about the idea that the market that they talk about in the news or our friends is always gonna be the one that is most exciting either on the upside or the downside right now. What's gonna trigger the most excitement or the most fear?

"When people are saying this, "The Market is High" here's the question, "What market are they talking about?"

Paul Adams: So is it the S&P 500, is it the Dow Jones Industrial Average, The S&P Global 100, The Russell 3000, S&P Global 200, The Global Dow, Dow Jones Global Titans 50. What about The FTSE All-World Index series or The MSCI EAFE. You see, they're always talking about some part of the market doing well or about to fall apart. And the trouble for all of us is the news will shift that based upon what's going to keep you most excited and get you through the next commercial. Now, before we wrap up this episode, I think what's important is that we don't just look at these individual markets; let's instead look at what's the likelihood over a 40-year period that anything is going to totally fall apart and absolutely destroy your capacity to build long-term wealth. So let's just take a look at this simulated performance of sample asset class mixes. Now, what you're gonna see is one of the most popular indexes out there, The S&P 500 is listed on the far right. Now, for those of you just listening to the podcast, it's okay. I think I'll give you plenty of data here that will work well by audio only. The next portfolio is an aggressive portfolio, 100% equities, a this portfolio is diversified very similar to our Dimensional Funds portfolios, but only indexes, which gives us the capacity to back test for a total of 40 years.

Paul Adams: Now, when you look and you see all the list of these positive returns and some negative returns, let's just count it down. Now, I'm gonna go with the one that's more likely to be a portfolio. We'd have our clients in. And this is the 70 30, although I like 80 20 better, but the 70 30 back-tested benchmark indexes is what we're showing here in the growth column. So what are our negative years? Starting 1978, we have a negative year in 1990, a negative year in 2002, that was the tech bubble. A negative year in 2008, a negative year in 2011, 2015 and most recently, 2018. So we have six negative years in a span of about 40 years, 41 years in this case.

Paul Adams: Six negative years out of 41 years. You see, staying invested... Which by the

way, over that period of time an average annualized return of 10.46%. But what we're not talking about is we're trying to blow out the market. We're not trying to beat the market terribly. All we wanna do is capture the market's returns. And all it took was one misstep during the big tech bubble. All you had to do was get distracted at what seemed like low returns in the years prior, less than 1%, less than 2% returns, the two years prior to the crash. And you get mad at your advisor, and you tell them that they're screwing you because you should have been in Yahoo or Cisco or EarthLink or NetZero. Any of these companies that now don't exist in any form similar to what they had then, and you get distracted and you lose 80% of your assets because you went all NASDAQ. Or you had a similar experience in the mid-2000s. You had friends that were just killing it in real estate. Sure, they were leveraged, but look at how real estate keeps going up. And they're not making any more of it. It's a no lose situation.

Paul Adams: And then your portfolio, if you had it, would have gone down 27%, but people lost everything who were speculating in real estate. Or they were in first deeds of trust, and not only did they lose a huge chunk of their money, they then had to hold on to the real estate for years and years to then try and offload it to recover some of what they had. Meanwhile, you would have been fully rebounded in two years with an academically allocated, globally-diversified portfolio as long as you held strategy. Now, we can watch that through time. It's pretty easy to get a chance to understand that the market does go up and down, but it goes up far more often than it goes down. If we wanted to use the example of speculating and gambling, speculating and gambling is pulling up to the table and playing blackjack as the player. But when you look at the fact that only six years were negative out of 41 past years, that is much more like being the blackjack dealer.

Paul Adams: You see, casinos are playing real strategy. They're investing in when they build a casino; they're not gambling. When you walk in and play a game against them, they know they will lose some of them. But what's gonna happen over time? They are going to win over time, which is why they have these huge buildings. And the same goes for you. Every now and then, either at a cocktail party or some news article, you're going to see somebody that bucked the trend and speculated and they won big. Great, that's the one person that got the media attention, not all the people that lost significant amounts of their life savings with their bits of speculation.

Paul Adams: So, we're gonna continue this in the next episode, but let's just close out today with our fun giveaway, as always. I wanna remind all of you give us an honest review. Send that to us to info@sfgwa.com. We are so thankful when we get those; it makes us smile. It makes mine and Cory's day. Would you please write a review to this podcast? And if you feel like, "I don't know how to write a review for this podcast." What I would do is Google, "How to write a review for a podcast." I promise you, it'll be three easy steps and you'll be able to have it. But once you do that, take a screenshot from your phone, email to us at info@sfgwa.com with a good mailing address and we'll send either a copy of Sound Financial Advice, Michael Michalowicz's Clockwork, or Cory's book Cape

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not Required. And we always look forward to get those from you.

Paul Adams: But let's talk about our featured review today. This is from somebody who I'm not related to but is very fun. It says, "C Adams 0502: Really informative and helpful. Helped me think more about why and if I should be making the financial decisions I am making. I would highly recommend this podcast." I thank you so much, C Adams 0502. I hope you had a chance to send a screenshot of that to us and we'd love to get you one of those books. And for all of you, join us in the next episode. We're gonna go a bit deeper into the meat on this, and some of our own research we've done about whether or not the market is really that high or not. And as always, we hope that this episode has been a contribution to you being able to design and build a good life.

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