Active or Passive Management: The Behavioural Explanations of Factors

[INTRODUCTION]

[0:00:05.3] Benjamin Felix: This is the Rational Reminder Podcast, a weekly reality check on sensible investing and financial decision making for Canadians. We are hosted by me, Benjamin Felix, and Cameron Passmore. I just want to say.

[0:00:17.5] Cameron Passmore: I know where you're going with this now.

[0:00:19.0] BF: It's been 32 episodes and I've done that intro perfectly every time, we've never had to really –

[0:00:23.5] CP: You've never tripped on the intro, I don't know how you do it and there's nothing written down at all. You've got a cold.

[0:00:28.9] BF: I think I've got it now. We'll see, maybe next time I'll mess it up. On today's episode, I think the focus was sort of answering a handful of client questions that we'd had come in. We talk about a few articles as well but our goal for the year is really to get into a rhythm of alternating between guests and ourselves. The rhythm's been a little crazy because –

[0:00:56.6] CP: We've kind of overbooked guests.

[0:00:58.3] BF: You know what? People were way more willing and even excited to come on as guests.

[0:01:03.7] CP: People have been incredible.

[0:01:04.7] BF: It's been hard to — like once you ask somebody, you don't want to say, "Okay, well, six weeks from now, whatever." Yeah, anyway, we asked a lot of people, a lot of people were excited to come on and yeah, now you get to hear them I guess.

[0:01:17.4] CP: Yeah, coming up, we have Rick Ferri, Jonathan Chevreau, Rob Carrick, Lindsey Plum, phenomenal interviews.

[0:01:27.1] BF: Yeah, that's true, worth pointing out is the next — well, we've got one episode of that coming up but the next handful are with guests and then by what? April, we'll be hopefully into our regular rotation of alternating between ourselves and guests.

[0:01:41.7] CP: Yup.

[0:01:43.2] BF: Anyway, we're still having lots of fun with the podcasts and we're glad people are listening. More and more people are listening, which is, I mean, super cool for us. If you are listening and enjoying the podcast, it's really exciting for us when people review the podcast and leave ratings. We get notification and it's exciting. So if you're enjoying the podcast, that would be appreciated.

[0:02:06.3] CP: It's also really cool to get questions. We've had a number of people email us questions.

[0:02:09.9] BF: Tons of questions.

[0:02:11.1] CP: Even in client meetings, people are mentioning it quite often.

[0:02:15.0] BF: That's the thing. You know, to me, the most – I don't know what I'd call it interesting or impactful, think about doing the podcast is the, not just the sheer number of clients but the clients that I would never expect to enjoy this type of content are listening to the podcast.

[0:02:32.3] CP: I had someone told me last week who I never thought would listen and he said, "You know, I have to tell you, I think the podcast is awesome," which is very kind, it's not the point. But he says, "I'm learning stuff I never thought I would want to know or that I should know, but I'm really liking it."

[0:02:49.8] BF: That's cool.

[0:02:50.3] CP: That's pretty cool.

[0:02:51.4] BF: That's the cool thing about podcast, you get exactly what he said, you get to hear stuff that you never even thought you wanted to know. Anyway, this intro's getting a little sentimental.

[0:02:59.4] CP: Here we go. Anyways, have a listen.

[INTERVIEW]

[0:03:06.7] BF: Welcome to episode 32 of the Rational Reminder Podcast.

[0:03:10.8] CP: Pretty incredible, 32. Anyways, so we have a bunch of stuff to clean up this week including questions from listeners and clients. Did you see this crazy opinion letter that was in the Wall Street Journal? Got a kick out of Cliff Asness who people who heard us talk about. He said, "This is one of the dumbest things you'll read about investing, possibly about anything." So it's a letter to the – it's an opinion letter in the Wall Street Journal talking about how I'd say, "Index investing harms investors much more than sales charge does. Contrary to Vogel's proclamation, you do get what you pay for." Vogel of course always talks about you get what you don't pay for.

[0:03:49.2] BF: But the guy, the person writing this opinion article took the Vanguard 500 index fund, right? And compared that to an actively managed mutual fund, one fund.

[0:03:59.3] CP: One fund.

[0:04:00.1] BF: They just grabbed a fund and said, "Look, look active management wins."

[0:04:03.9] CP: Of course it blew it away but I think almost 3 percentage points a year, which ended up being about one $1.8 million dollars more over the 42 years. It was basically on the 42nd anniversary. The founding of the Vanguard S&P 500 fund.

[0:04:16.4] BF: But obviously, you can't just go and pick one active fund that's done well and say, "Therefore, active management is good."

[0:04:23.7] CP: Completely ridiculous. Cliff Asness just shredded it and anyways, a little throw away for you.

[0:04:28.9] BF: Of course, we know that if you took all the data on all of the actively managed funds, over that period of time, I bet you I would bet it's 100% of them are under performed the index, over 42 years? Even when you look at 10 ears, it's like 95% of active funds under perform the index.

[0:04:44.5] CP: So it's not a hundred because someone found one, right?

[0:04:48.1] BF: Yup.

[0:04:48.5] CP: You found another article talking about the momentum factor is real, too bad it doesn't work.

[0:04:53.4] BF: Yeah, it was in Institutional Investor based on research done by dimensional. Here we go talking about Dimensional again but –

[0:05:02.6] CP: And factors.

[0:05:03.5] BF: And factors. But they basically just showed that the momentum factor, it's a real thing and it has had positive frames over time. But Dimensional studied a bunch of US equity funds that are using momentum and what they found was that the funds were actually able to capture the premium. They were able to capture the higher returns from momentum, which is pretty cool. But after costs, they did not deliver the premium to fund holders.

[0:05:30.5] CP: What are the cost they're talking about?

[0:05:32.7] BF: Trading costs.

[0:05:34.1] CP: So actual brokerage cost plus bit of spread I would guess?

[0:05:36.9] BF: Probably, a combination of the two, yeah. They looked at 11 funds, 10 of the 11 funds in the study, under performed the Russel 3,000 index and they had turn over that ranged from 60% to 211% annually, which is what you would expect from momentum. But the point of Dimensional's paper was just saying that, yes, momentum is real, yes, it's there, yes, it can be invested in but after transaction costs, you're probably not going to get, well, in this case, you got a negative premium after cost.

[0:06:09.3] CP: Yes. These were funds I assumed that made their decisions based on momentum, which is built a realm momentum where as in Dimensional's world, they used momentum in their trading decisions, it's not specifically a momentum-style fund.

[0:06:24.5] BF: That's always a thing with momentum, it's like yes it's there in the data. Is there a good risk reason for it to exist? Questionable. So you're incurring all of these high transaction costs to capture this thing that might not persist and if it doesn't persist then you've paid all these costs so you're basically going to lose.

Plus, momentum's been super volatile. Anyway, that's – I think we've talked about this in the past episodes, that's why we don't try and seek out momentum products and Dimensional's not using momentum in their funds just because it's potentially inconsistent.

[0:06:58.7] CP: Yeah, they use it in their trading decisions. At time of trading, they have momentum overlays.

[0:07:04.4] BF: That's right, that's a better way of describing it than saying they don't look at it at all. We talked about that in the episode with Brad from Dimensional. We have a couple of client questions that we want to go through and before we get to that, there's an article that was in, I think Investment Executive that speaks to one of the client questions.

So the article was talking about how indexing isn't really passive and there was a paper from somebody at the University of Toronto and they looked at – I didn't read the paper but the articles said that they looked at a bunch of different index methodologies and basically said, based on how indexes are constructed, index investing isn't as passive as people think because there are a ton of decisions that go into index construction and reconstitution and all those different pieces.

One of the things that the paper concluded with was, one of the big takeaway's of the paper at a high level is that indices like so much else in finance and asset management are really the result of decisions made by people. The way that dove tails in with the listener question –

[0:08:09.9] CP: I guess it's all about labels, right? It's a whole lot of questions on, active versus passive and I certainly don't believe what we do is passive in any stretch.

[0:08:18.2] BF: Depends on your definition. Who says what?

[0:08:21.4] CP: Correct. That's what I mean. So you can just debate labels all day long.

[0:08:23.7] BF: I think that you could, if you're going to say, there's just as much argument to say Dimensional is either passive or active as there is to say the S&P 500 is either passive or active. I mean, you look at the methodology for the S&P 500 and it's like they've got a whole bunch of quantitative characteristics that they use to screen for stocks and then once they have a pool of candidates that meets those quantitative criteria, they've got a committee that decides together which stocks belong in the index. I mean, tell me that's passive.

[0:08:53.1] CP: The passive part might be the fact that you could buy a fund that just replicates that. So it's just a copycat vehicle, is that the passive part?

[0:09:00.0] BF: I don't know. I think that they're saying that — the argument would go that the index itself is passive. What's a passive index? That's the whole point.

[0:09:07.0] CP: Russel 1,000 would be passive because it's the 1,000 largest stocks in the US market.

[0:09:12.3] BF: Why is that passive?

[0:09:13.9] CP: It is what it is. It's the 1,000 largest on the market cap bases. There's no one deciding who's in or who's out. It's just how big you are.

[0:09:20.6] BF: Based on Russel's analysis.

[0:09:23.2] CP: Which is just adding at market cap, right? So that, you could make a better argument that that is passive.

[0:09:29.0] BF: But there are different US total mark indices too. Like vanguard uses a CRSP 110, iShares uses something else.

[0:09:35.0] CP: Yup, I agree.

[0:09:35.4] BF: They're not the same index. I mean, you can even think of it from a tax law selling perspective, if you can use them as tax law selling pairs then by definition, they can't be the same index.

[0:09:45.0] CP: Yup.

[0:09:45.7] BF: Anyways, the question that one of our listeners had was you guys talk about factors all the time and you basically sound like active managers like people that read Couch Potato and people that have the whole market cap index.

[0:10:02.2] CP: Actually a client asking that last week, when I met with them I said, "I listen to all your podcast and it sounds like you guys have gone to the dark side." This is a really – he's a smart guy, he knows what's going on, he gets all that we're doing. I guess he didn't realize until listening to us, there's such a focus on the factors. Maybe we've over focused here on the podcast. It's important people do understand how these things are constructed.

[0:10:25.8] BF: I think there's an appetite for the factor stuff because I get self-conscious about how much we talk about factors because I don't want people to think, "Oh, they're talking about factors again." I know you've had that comment from one person at least but at the same time, the most questions hands down that we get are about factors.

[0:10:43.1] CP: How was using factors not another flavor of active management? How is it not on the dark side?

[0:10:48.9] BF: You answer first and I'll answer the way I would answer it.

[0:10:51.4] CP: I explained to him that the main decision that you make, which explains so much of your returns is getting exposure to stocks versus other less risky assets like bonds or cash or T bills. You've already made a decision to do something to take on higher returns, that's the market factor, he gets that.

I said, "Well, if you're going to follow that factor, you have to respect other factors that have been discovered and shown to be statistically sustainable," and the ones that I think we believe you agree are the most important ones would be exposure to a small stocks, the small stock factor and then the price factor. Shares, whose price has gone down.

They typically have higher expected returns going forward, this is well documented, it goes back decades of research, peer reviewed research. So I said, “I don’t believe you can accept one but describe the other two, they come from the same place of science.”

[0:11:48.3] BF: I would answer it very similarly, just from a different angle. But the essence of my answer is I think the same. The way that I think about this is anything that respects market efficiency and is based on the market being efficient, that is not traditional active management. Anything that invests based on markets being inefficient is active management. Investing based on markets being inefficient, that’s picking individual stocks, that’s trying to time the market.

But now here’s where it gets really confusing and it is really confusing. There are factors that are based on the market being inefficient. You look at the – what were the ones we were talking about recently? Well, momentum is one that has a behavioral explanation, a behavioral explanation for a factor, by definition, means, markets are not efficient. Then, even at the extreme when we’re talking about factors, there’s RAFI, which is the fundamental indexing company and they build indexes based on what they call fundamental factors. Which are their stuff like what do they call them, economic footprint or something like that. But they’re all – when you’re looking at fundamental factors, fundamental factors are trying to find undervalued stocks. Undervalued meaning that they’re – well, they’re value is wrong.

[0:13:06.1] CP: That’s what I was just going to say. So the factors I described, you believe prices are right, they reflect the risk.

[0:13:12.5] BF: Yes.

[0:13:12.9] CP: The small stocks are riskier, therefore, they must have a higher expected return. A share goes down for some reason, there must be something bad going on, therefore, price is going to go lower, therefore it has to have a higher expected return if they as a group survive. So it's about accepting and assuming they're right as supposed to assuming they're wrong. Maybe here's your definition there factor versus –

[0:13:33.9] BF: That's how I would define it, it's assuming markets are efficient, as long as you're investing based on markets being efficient, you're a passive investor. I don't know if passive is the right descriptor but for the – what the people are asking about is I think that's what gets to the bottom of it where if you're investing based on markets being efficient, you're a passive investor.

[0:13:53.9] CP: But the part I don't get about undervalue, okay so you think it's undervalued, that means the person on the sell side to you is wrong. They have to be wrong again to overpay you later on to buy it back? I don't get that loop.

[0:14:07.6] BF: Yeah, I guess you could call it pretty arrogant loop to have that – to think about being able to be right on two sides of the trade. Does that answer the question, do you think?

[0:14:17.7] CP: Well, I'll ask them to find out, I hope so. He'll ask me again if it doesn't.

[0:14:21.3] BF: Yeah. Any factor that agrees that markets are efficient but allows for higher expected returns, that's not active. Anything that assumes markets are inefficient, that is active.

[0:14:33.5] CP: I think it's very responsible to present these factors that clients, given how much evidence there is behind them.

[0:14:39.9] BF: For sure.

[0:14:41.3] CP: Here's another question to follow on that, someone who does believe in factors and wants lots of factor exposure and can handle the tracking error owning those factors. He asked me, "Why are you not blind to borders? Why don't you just follow where the cheapest and smallest stocks are, regardless of where they are in the world? Why do you put these constraints on country allocations?" Which I believe are more or less market cap constraints.

[0:15:07.8] BF: Yeah, well, it starts with the whole point of investing is capturing the net gains of capitalism and as soon as you go away from market as a starting point, you lose that. You're placing an active bet. An active bet does not have a positive expected return. If you own the whole entire market, you've got a positive expected return. If you pick one segment of the market, one little piece and hope it does better than the market, you've lost now or at least you've introduced an additional risk that does not have a positive expected return.

Because if you own this little segment, it's either going to do better or worse than the market with no way of knowing ahead of time what's going to happen. Although, statistically, you're far more likely to do worse than better by picking this little segment. When you start talking about stuff like waiting purely, well, it's fundamental indexing.

That's the same thing or at least very similar to what you were just talking about, where, if you're just betting on – well, it's a little bit different. If you're betting on a certain factor, it would be active management in a sense.

[0:16:10.8] CP: You could end up with some pretty extreme positions, which could go very wrong.

[0:16:14.6] BF: That's the problem. Because you've now gotten away from market. You're just betting on the factor. You could bet on any factor. Like in this case, if we're talking about value, that's what favors — Camber ETF's, that's what they do. They look at the cheapest, I don't know how many, cheapest sum number or countries and they buy those and they rebalance I think once a year. Again, that's the same thing where if you're only betting on that, you're basically just betting on value. A value doesn't work, well, that's it, you didn't get market in that case.

[0:16:46.9] CP: Next question, given your YouTube video we did on dividends that was so solid. Again, client watched the video, totally gets it, totally agrees, 100%. Then he asks this head scratching question. If you happen to have a company that was mandated to never ever share it's profits, so no buy-backs and pay no dividends, how was that stock not worthless?

[0:17:13.9] BF: Yeah, I thought about that one a lot. Did you think about an answer?

[0:17:17.2] CP: I thought about the question. I don't have a great answer for him.

[0:17:20.2] BF: I think the best answer that I can think of, if we assume that the company is never going to return capital to shareholders, the best answer that I can think of is that as long as it is still generating cash, we have to remember that when an analyst does an evaluation of the company, they are not using dividends. Well, they might be using that but typically they are using cash flow, which is different from dividends. They are using what the company's free cash flow is and they are discounting that back to present day.

[0:17:43.7] CP: And I guess the balance sheet as well.

[0:17:45.4] BF: Well if you're doing a discounted cash flow evaluation, yeah I guess you –

[0:17:49.0] CP: Yeah but if the company is making money and just plowing that.

[0:17:50.8] BF: Plus book value.

[0:17:51.9] CP: Yeah.

[0:17:52.3] BF: Yeah, present value, future cash flows, plus book. I believe that's – not that I am a DCF for a long time, so someone may correct me on that but I am pretty sure it's right. Anyway so as long as that company is generating cash, it still has value from that perspective. Now, if they're never going to return any of that cash to shareholders, why should they care? I think that the answer to that is that somebody could, hypothetically, somebody couldn't buy all the shares from everybody and if they did that, they would now have the cash flow of the company, which they could use to invest on other projects that they liked. So as long as that is true, as long as somebody could hypothetically go and buy all of the shares and have access to that cash the stocks will still have value, does that make sense?

[0:18:34.9] CP: It does to me.

[0:18:36.1] BF: I thought it made sense. It is an interesting question though. Took a little bit of thinking. I want to follow up too on the active versus passive factor-type questions. One of the other questions that we got from a few people was some variation of, “You guys always talk about factors but I still have no idea what that means," which is probably a miss on our part because we did just jumped into talking about factors as if everyone knew about it.

And one of the comments that somebody made to me was, “It would be cool if you guys just did an episode where it was as if you were explaining factors to your mom.” I was like, “Okay.” So Cameron and I started talking about that. It is a pretty good idea and then I was like, “Wait, we could actually just have my mom on an episode and explain factors to her.” So yeah, that will be an upcoming episode. We are going to have my mom on and we’re going to explain.

[0:19:31.5] CP: And what is cool about your mom is she is a researcher, she is very highly educated, very bright but she doesn’t know a lot about the investment world.

[0:19:40.1] BF: Nothing.

[0:19:40.6] CP: And it will be fun to do it and she will also reign us in when we get off on our geek outs. So I think that is a great idea. So we’ll have that come up on a couple of weeks.

[0:19:53.1] BF: Yeah, you posted an interesting article on some research from CIBC.

[0:19:58.1] CP: Yeah, I looked at and we talked about this with a number of guest lately about pre-retirement and preparing for retirement. So this is a study put out, it is a poll by CIBC talking about regret that retirees have once they retired. So get this, 27% of retired Canadians express regret about retiring.

[0:20:20.0] BF: Unreal.

[0:20:21.2] CP: 23% have tried to re-enter the labor market. 59% say they chose to return to the workforce for mental stimulation but 50% of respondents also cited to other financial concerns. So Jamie Golombek who is the Managing Director of Financial Planning and Advice at CIBC said, “Too many Canadians approach retirement without a plan, which can lead to unnecessary stress, worries about money and even course corrections.”

So who was it that we interviewed lately that talked about, you know you go into business, you have a business plan, why would you not have a plan like that for retirement like what are you going to do with your time? Is it John Chevreau?

[0:21:00.3] BF: It was either Chevreau or Rick Ferri. I don’t remember.

[0:21:02.0] CP: Rick Ferri. So we got great conversations with three guests coming up talking about this exact subject and it is so important to think about what your days will be like once you do retire.

[0:21:12.8] BF: I think that the two guys we talk about, Rick Ferri and John Chevreau, both of those guys are I guess recently retired-ish. Chevreau would call it his victory lap, but they are both hyper into the idea of well, not retiring or at least they are working not because they have to but because they –

[0:21:33.7] CP: Well they’ve spent their whole career communicating a message trying to have an impact on Rick’s case on America’s Financial Lives and in Jonathan’s case, Canadian’s Financial Lives. They have spent their whole career doing this. I can’t imagine how they would ever turn it off.

[0:21:46.9] BF: Yeah, I don't know how you do it but it is the same for anybody, right? I mean that's what Larry talked about this when we interviewed him too. In his book, he had a whole chapter on preparing for all of the – yeah, like planning your day. What are you going to actually do in retirement. Because if you do, if you plan to do nothing, I think that there are some serious psychological and even physiological impacts that that can have.

I talked to a client recently who is retiring next year and they were telling me all about it. They have already done this. They've got their plans laid out, they are retiring the same time as their partner. They've got their trips planned three years out all these kind of stuff and she's excited to retire and that's the way to do it. I think if you go into it, and this is the thing with the whole fire movement. Who do we talk about this with recently? Rob Carrick?

[0:22:31.6] CP: Rob Carrick and Chevreau.

[0:22:33.9] BF: I think that I talked with you. I chatted with somebody about this recently too, off the air and they asked me, "What do you think about the whole fire movement?" and I think the whole thing is completely misguided. Because I think people think about the extreme saving without a real vision for what retirement actually looks like.

[0:22:52.6] CP: I don't get this almost hatred for working.

[0:22:54.9] BF: Yeah.

[0:22:55.6] CP: It is not like we're working, many people not working in the old factories at the coal mines at their 40s or 50s or something. Many people are doing such stimulating work. It goes back to what Brad said, you know, when he talked about happiness that perma, you know ease for engagement, being engaged in something, being on a mission, being on something that is interesting and fulfilling for you.

[0:23:17.2] BF: It would be cool to get a guest on who is like a real fire blogger that is passionate about doing nothing and see what they're like, "What do you want to do?"

[0:23:26.7] CP: Well if you are out there drop us a note, we'll get you on.

[0:23:29.8] BF: I know of one person that may be interested. Rob I think might come on to do an episode about fire but he has a similar perspective as us. So it wouldn't shed light on what the real intrinsic motivation of somebody is to do. Do they want to do it? Anyway.

[0:23:44.0] CP: So here is another question for you, what do you make of well simple premium advice coming to the market place?

[0:23:49.2] BF: It is pretty cool. I mean it is interesting anyway. So it is half a million dollar minimum, same 40 basis point fee that they are charging everybody else over a $100K but it sounds like the pitch is more access to advice, which makes sense because that's what people want. Yeah, I mean it is all going to be in the experience, the delivery and the expertise that they have I guess. That is what it comes down to. Right now they're just – we talked to Rob Carrick about this on the episode today that – Was that in the episode? I think maybe that was when we were just chatting with him but all these Fin Tech firms are circling back to a traditional wealth management or financial services model.

[0:24:26.9] CP: That is frankly what people want.

[0:24:29.4] BF: Yeah.

[0:24:29.9] CP: You know, people have questions. We say that all the time. But I got a kick out of the CEO Michael Katchen in saying, "We won't schedule face to face meetings but we'll be there for you and your family whenever and wherever you need us."

[0:24:42.9] BF: FaceTime and Skype and stuff I guess?

[0:24:44.9] CP: I guess so, but it's up to you to reach out.

[0:24:47.5] BF: Oh.

[0:24:48.2] CP: They won't reach out to you. You have to reach out to them. So we are here for you when you want.

[0:24:52.2] BF: Oh really?

[0:24:52.7] CP: That is just a quote I read in the article that was in our trade publication.

[0:24:56.4] BF: You know I don't know. I get that people get like technology and I know that our sample is biased because we have people that have obviously chosen to work with our firm but we deal with a lot of tech-forward people and I can tell you the amount of video meetings that those type of people book is a fraction of the face to face meetings that they book, if given the option. So I don't know, yeah we'll see. I mean maybe we won't see because they're not going to do it.

[0:25:28.3] CP: Well it's the perspective too, you get from dealing with the person. I listen to a great podcast, a client referred me to the podcast On Being and they interviewed Daniel Kahneman who is an incredible behavioral economist, Nobel Prize winner, unbelievable thoughtful interview on this podcast talking about how behavior affects how you make decisions and I tell you, you listen to the biases we all have.

We are absolutely hardwired to do, you can really see this is a behavior story. You can talk about factors all you want, which makes sense but boy, if you don't know how to behave through this factor and through markets going up and down, I mean that is where I think so much of any advisor's value proposition is.

[0:26:07.9] BF: What is the whole discussion around tracking here? Who do we ask that question to? WAs that Larry? What is the downside of investing in factors? Larry is big on factors.

[0:26:16.2] CP: Yeah.

[0:26:16.9] BF: Man, I feel bad talking about factors again but this thing just popped in my head. So we had Larry Swedroe on as a guest and we had Rick Ferri on as a guest. Both of those guys are big names in the financial blogesphere I guess in the US, big names. Like those are guys, those are the resources and it is so funny to talk about to listen to Larry to talk about factors and he's like, "Oh, you absolutely need them 100%. You're crazy if you don't have them."

And then you talk to Rick, and Rick, I mean he is just a complete different perspective. He is more focused on simplicity. Yeah the factor they're there but people don't really know how to define them. Like how they define value? How they've –

[0:26:52.7] CP: Let me say just have the cake. Yeah there is icing, great but just have the cake.

[0:26:55.7] BF: Yeah, so interesting to hear those two different perspectives. That caused me to lose my train of thought. Where were we?

[0:27:02.4] CP: Oh I was going to talk about returns as well.

[0:27:06.0] BF: But how did we get into – you were talking about the factors.

[0:27:09.2] CP: Well the behavior, the value dealing with a person.

[0:27:10.8] BF: Right because that is what Larry said is the behavioral issue of when we asked him, "Is there ever a time when factors are not good?" Then he said, "Well yeah if you can't handle tracking error." Why would you care? Yeah.

[0:27:23.3] CP: Last year we were tracking error in the portfolio. Not huge. Nothing that sounds surprising but we spend a lot of time preparing people for tracking error.

[0:27:30.7] BF: Pretty meaningful though. Pretty meaningful compared to the market. I mean, the big thing in the Dimensional portfolio is that they're currency hedged and the currency worked in favor or a Canadian, an unhedged Canadian investor big time last year. Small in value, the tracking error was huge. Currency told most of the story, small in value had tracking error as well but we –

[0:27:56.6] CP: The gold equity fund last year was down 9.7% and some of that's already been made back in January. Up 6.69% so far in January.

[0:28:05.8] BF: Yeah, I looked at the dollar invested in January 2018 dropped to 90 cents by December 2018, by the end of the month and by the end of January 2019 was back up to 96 cents. So that speaks the importance of – I mean obviously I think people will get this but if you are going to be invested, you got to stay invested to get that six cents back so far in January. Obviously if you bailed out in December because you are sad about the portfolio dropping.

[0:28:32.6] CP: So I loved a tweet that Med Favor put out last week talking about how over the past seven years, the US market is out performed foreign stocks by 1% per year. So you say, "Wow, I guess you should have focused on the US marketplace." That is kind of in Jack Bogle's message forever. Then he asked, "How much of that out performance to seven years, how much of the out performance over the seven years happened or was caused since 2009?" and the answer is all of it. Unreal, the last decade. So coming out of the financial crisis in the last 10 years has driven that spread of 1%.

[0:29:11.8] BF: I believe it. Do you remember that article that we talked about before the holidays, *The S&P 500 Goes Supernova*? And it showed that the statistical that the probability of the actual performance of the S&P 500 over the trailing 10 years was basically statistically impossible, but it happened.

[0:29:29.7] CP: Yeah and then someone who we're going to have on the podcast in a couple of months, Eric Nelson jumped in as he always does with some great data points. They just pulled off data point going back to 1970, so 48 years. So it was 48 years. His point, I think, was just to show the spread of returns in part of that sample set. Maybe S&P 500 is up 10.2, the US small was up 14.7 so there you return to see some factor of performance there.

MSCI world excluding the US was up 9.1% again, we are 48 years. The international small is up 13.9%. So his point just jumping in was you need lots of different asset classes over that time period and you can get great returns. You don't have to focus just on the US marketplace.

[0:30:19.3] BF: Well for sure, it is kind of a joke that I hear about Canadian investors where it always – that the sentiment always flips. If Canadian stocks are doing well then Canadian investors just love Canadian stocks and they love the home country bias and portfolios but as soon as Canadian stocks start trailing the market everyone is like, "Oh home country bias. Why do we have so much Canada," and it always just flip flops back and forth based on what's been doing well.

[0:30:44.9] CP: So what do you make of this crazy Bitcoin exchange story?

[0:30:48.4] BF: Missed it.

[0:30:48.9] CP: You didn't see it? It's been flying around the office here today. So this is the largest Bitcoin exchange in Canada, the access to the wallets was lost when the CEO die from complications of Crohn's disease.

[0:31:02.3] BF: Are you serious?

[0:31:03.5] CP: Like a $190 million I believe of Bitcoin just gone because no one has the passwords for the wallets.

[0:31:09.9] BF: That is wild.

[0:31:11.9] CP: And this is a store of value.

[0:31:13.8] BF: I think it was MBR who had, it was a while ago now, a couple of years ago even. They had a great episode on what does decentralization actually mean and that's it.

[0:31:26.0] CP: Well that's de-central. It is actually pretty central, I guess.

[0:31:29.5] BF: Well in that case it was –

[0:31:30.6] CP: Sad for the CEO of course.

[0:31:32.3] BF: Yeah, it is. That is sad. They gave the example of US currency where if your US dollar bills or any bills are damaged in a fire or whatever, you can take them back to – I can't remember what it is called but it was some specific department of the government and they will replace the bills based on the serial numbers. Bitcoin you lose it, gone. That's it and that in the US dollar's case that's the benefit of centralization. You didn't formally did that interview a long time ago for some website called Coin Telegraph.

But they are trying to give formal leading questions to say that Bitcoin is a good thing and Fama is like, "Yeah but who cares about decentralization? Like drug dealers, that's it." That is what Fama says. It is kind of true though, who really does care about decentralization?

[0:32:19.1] CP: So pop culture question for you, have you seen the documentary on the Fyre?

[0:32:23.8] BF: I watched it. That was crazy.

[0:32:26.0] CP: Fyre, for those who haven't seen it or heard of it.

[0:32:30.1] BF: You know, it was a small – well it was a big part of the story but in the way that they told the story, it was a small piece but he was committing securities fraud the whole time. That was the craziest part. Like they just glossed over that at the end.

[0:32:43.1] CP: And everybody went along with it, which blew my mind.

[0:32:45.8] BF: But he raised, was it $25 million of capital?

[0:32:48.2] CP: It was a lot of money and it was all a sham. Complete sham. Good intentions but.

[0:32:54.8] BF: That's what you'd love to know. You would love to know what was going through his head. Did he think he could pull it off and it was just a badly managed project?

[0:33:00.7] CP: What a disaster. It is a great documentary, fascinating. Yeah, what have you been reading lately?

[0:33:07.3] BF: I picked up a book called *Never Split the Difference*, which is a book on negotiation by a guy named I think it is Chris Voss but he is a former FBI negotiator and he went to the Harvard negotiation class or school, or whatever, which is apparently the negotiation place to go and through that experience he was able to distill the practical experience that he had as an FBI negotiator like dealing with terrorists and things like that.

He was able to distill that and combine it with the actual psychological research and he forms some pretty cool ideas on negotiating and even just talking with people. So that has been pretty cool so far.

[0:33:52.4] CP: Amazing. I have been reading *Sapiens* at your and many others recommendation.

[0:33:56.3] BF: And?

[0:33:56.9] CP: Incredible book, incredible where we have come from, how we develop, how we organize ourselves, how we relate to each other.

[0:34:04.5] BF: The chapter on capitalism to me was a bit of a let out. I mean it was fine but I was expecting –

[0:34:09.8] CP: Yeah, I am not there yet.

[0:34:10.7] BF: I was just expecting more. I don't know how else to describe it. I was most excited for that chapter and I got there and it was kind of like, "Ah, not that good."

[0:34:18.5] CP: Okay, well I'll wait for that. Anything else on your mind?

[0:34:21.6] BF: No I think I am good.

[0:34:22.7] CP: All right that is it for this week.

[END]