**The Rational Reminder Podcast Ep.33 - Low Cost Index Investing: What You Need To Be a Successful Index Investor**

[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. Today, we had a great guest. All of our guests are great, I think I’ve said that before but we had Rick Ferri. Anyone who follows or is interested in index investing will probably have read something of Rick’s, he’s written seven books, working on the eighth but he’s written a ton online as well and he’s been – he used to be I don’t know if he still is extremely active in the Bogleheads online forum.

**[0:00:37.4] Cameron Passmore:** He’s an absolute leader in the space to have gone to Jamie Dimon, who was the head of Smith Bard in the mid 70’s, and propose a low fee asset allocation portfolio using ETF’s and was turned down, a resounding turn down, that’s pretty incredible.

**[0:00:52.3] BF:** Yeah it is. I mean, Rick’s impressive, right? He was in the marines before coming into financial services and then, like you said Cameron, he really spearheaded this movement, and he opened I don’t know if it was the first but was it the first, Portfolio Solutions, the first kind of low fee index fund-based wealth management shop?

**[0:01:09.1] CP:** I believe so. Built it up to over a billion-dollar company.

**[0:01:12.3] BF:** But he kind of created that model of fiduciary advice, low cost, using index funds, putting the client first.

**[0:01:19.5] CP:** He’s certainly one of the earliest most vocal supporters of this approach and as you told us, you had to keep telling the truth time and time again to get the message through. Now, he doesn’t have to work as he says but he’s on a journey to tell people about this.

**[0:01:32.7] BF:** He’s so passionate about, I think that comes out through the conversation but he’s just so passionate about this stuff and we talked for another 30 minutes after we stopped recording, I think he could have gone on all day, which I was happy to listen to.

**[0:01:43.1] CP:** Yeah, terrific guy and very gracious of him. Talks about his relationship with John Bogle who recently passed away, it was a pretty meaningful conversation.

**[0:01:51.7] BF:** Yeah, anyway, it was a great conversation so we hope you enjoy it.

[INTERVIEW]

**[0:02:00.7] CP:** Rick, welcome to the Rational Reminder Podcast.

**[0:02:03.2] Rick Ferry:** Thank you for having me today.

**[0:02:05.3] CP:** I’ve been looking forward to this for years, I followed you for years, I’ve seen you at a Dimensional Conference in the past and I think it’s safe for us to say that you’re one off the founding fathers of bringing low cost index investing mainstream and I’m really curious, what made you so passionate about spreading this message?

**[0:02:24.1] RF:** Well, you know, when I first started in the industry, I had come out of the marine corp. I had done eight years in the marine corps and truth and integrity are everything in the marine corp. your life depends on it and I was always very precise about providing accurate information, I mean, to my troops.

I was a pilot, I used to fly jets on aircraft carriers and it’s all very precise, it has to be very accurate, the people who are working on your aircraft have to be accurate, precise and truthful. Especially the people who were working on the ejection seat, that was pretty critical. When I got into the investment industry, I found a world that was completely opposite of that.

There was very little truth that I found, a lot of misconceptions, a lot of misrepresentation and it bothered me greatly right from the beginning. I decided I needed to know more, I went out and achieved my CFA, I received a charted financial analyst charter from the CFA institute.

I went and I started a master’s program in finance where I studied mainly economics and statistics. Anyway, I was looking for truth in the investment industry and there wasn’t any. I was very difficult to find it. I had tried to pick investments, I tried to pick money managers, I had tried to many different things and finally, after reading every book I could possibly read, I picked up a book in 1996 called Bogle on Mutual Funds.

This is where I was enlightened. What John Bogle was saying in his book, his first book, which he had wrote about two years earlier was that it was very difficult to find people who were going to outperform and don’t even bother. Just buy the market and you’ll be better off and it was an epiphany. I mean, the light went on, I said, he’s right. I found there was other people like me out there. This was the path I was going to go on if I was going to stay in the financial services industry.

This was the path I was going to go on and what I believed in and that’s how I got started.

**[0:04:28.2] BF:** It’s really interesting Rick, index investing in general has come a really long way since you started in the business many years ago. You tweeted something late last year that kind of speaks to where index investors are now and I want to ask you about that.

So, your tweet was, “The education of an index investor, born in darkness, finds indexing enlightenment, overcomplicates everything, embraces simplicity.”

I thought that was a great tweet. But what I want to ask you is how much value do you think investors should place on simplicity versus indexing tweaks like adding small caps or trying to optimize asset location.

**[0:05:02.6] RF:** You are asking a whole bunch of questions all together and could I take a moment and talk about the four levels of an index or ghost route and as a successful indexer goes through to get to the last level, okay? By the way, I’m writing a book called The Education of an Index Investor and is exactly what you talked about, the four levels an investor goes through, they start out in darkness.

It doesn’t necessarily mean they don’t know anything about investing, they just are not measuring their performance and not capturing the fact that it’s difficult to outperform and hadn’t hit that enlightenment stage that I talked about a while back and my last answer. Well, at some point, if you are in this long enough and you measure your performance long enough and you’re honest with yourself and you’re honest with your ability and you’re also honest with what you can possibly know out there.

You eventually come to the realization that indexing, although it may not be perfect is a much better strategy than anything else that you could do for yourself. That’s the first stage, which is enlightenment. You go from darkness to enlightenment. But once you become enlightened, a lot of people start to absorb knowledge, they crave knowledge, crave books, crave learning, everything that they can about indexing and indexes and asset allocation and optimization and try to create what I call the perfect portfolio and this leads to complexity, you overcomplicate everything.

Part of that by the way, you touched on is the idea of factor investing, which is to add small cap in value and such. Which is not bad but it is, it adds a lot of complexity to a portfolio, people have difficulty figuring out how much should they have, which one should they have, how do you measure value? What do you cut off small cap, do you use micro-cap? What about international?

You start slicing and dicing and overcomplicating things in your portfolio to the point where you can get to paralysis by analysis, which is you sort of regress back to active management a little bit and it regress back into darkness a little bit because you’re really not capturing the essence of the enlightenment that you originally had.

When you hit that point and you realize that you’re doing this, you realize that a lot of the stuff that you’re worrying about and trying to find the perfect portfolio, really doesn’t matter in the long run. I mean, what really matters is your stock and bond mix and as you said, controlling cost, controlling taxes.

You go to a more simpler portfolio, fewer asset classes, fewer funds, maybe fewer accounts if you can consolidate IRA’s and such. You don’t worry about factor investing anymore, you might have it, it might enhance your portfolio but it isn’t the cake, that’s all that you realize is just the icing on the cake, it’s like a wedding cake, a white wedding cake.

The outside all looks different and it’s all beautiful to all different people but in fact, when you cut the cake, it’s still the same cake inside and when you realize that, you go back to simplicity and now you’ve reached the final stage of the education of an index investor.

Darkness enlightenment, complexity and simplicity. I’m right now all about simplicity, I’m all about keeping things simple. I realize, I’m also perhaps a little older than you, I’m in my 60’s now. To me, downsizing and simplifying are a big deal for me and a big deal for baby boomers in general. A part of that is making your portfolio less complicated, not giving up anything, just making it less complicated, not only for yourself but also for those who might inherit this portfolio later on.

If you only have four or five funds in there, it just makes it so much easier than complicating it up with 12, 13,15, 20 funds and a slice and dice portfolio. That’s what it’s all about.

**[0:08:55.5] CP:** What a terrific answer. To follow on to that, in the past year, Canada’s had a number of what we call one decision portfolios came out form I Shares and vanguard. Are you a fan of one decision solutions like that as opposed to the three or four, five ETF solutions?

**[0:09:12.0] RF:** Yeah, I mean, the one decision solutions are very simply, from what I understand, just fund to funds. Where, within the fund or within the exchange rated fund, there are other funds so it becomes a fund to fund. It’s a balanced portfolio where you don’t have to rebalance your stocks and bonds when things get out of whack. Now, the artist had this for many years and I know I shares now is getting on board, I think we’re going to see a lot more of that.

I mean, we’ve seen a real benefit in the 401(k) and in the retirement market here in the states with target date retirement funds. I think that more people are going to gravitate more towards these funds to funds where everything is done for you because it keeps you disciplined, the data shows that people stay in those funds as opposed to jumping out when markets go down or trying to change their asset allocation.

They tend to put the money in and stay there and that’s what you need to do in the long term. I am a fan as long as the fees are low.

**[0:10:10.2] BF:** Rick, you mentioned factors when we were talking about simplicity and I believe that with Portfolio Solutions, when you were there, you guys were using dimensional, is that correct?

**[0:10:19.4] RF:** Correct, we were using a couple of dimensional funds.

**[0:10:21.5] BF:** Okay, I know you’ve been critical of terms like evidence based investing and smart beta. I just wanted to ask, how would you describe dimensional funds?

**[0:10:29.7] RF:** Well, dimensional funds is an active management that uses factor based investing principles. They’re looking for systematic risks within the markets to try to isolate risk that cannot be diversified away. It might be small cap, it might be value, momentum, quality and so it’s a multi-factor type approach to adding risks in your portfolio in addition to market risks. These are additional risks that you’re adding into your portfolio in addition to market risk to try to enhance the return of the portfolio.

Although, you are adding more risk to the portfolio. Now, there is an argument that well, these factors are not 100% correlated and therefore you’re going to get a benefit from diversifying a different risk factor. That might be true but II don’t really count that personally. I just look at it as, I’ll take a little bit more risk, it might be a little bit different than just market risk that might enhance the portfolio return in the long term. I don’t go overboard on the whole thing.

**[0:11:32.3] BF:** That’s a great answer. I’ve got a little bit of a follow up question. One of the things that Cameron talked about in the podcast a while ago was funds from companies like AQR, which are kind of, they’re doing a lot to create additional independent risk factors. Now, we think that’s a little bit extreme for our client’s portfolios, what are your thoughts on I guess, none market risk factors fitting into a portfolio.

**[0:11:54.4] RF:** Yeah, of course, one of the problems, the way you do it if you’re doing it either just long only or you’re doing it long/short. To do it long only means you’re going to have a lot of beta. 80% of your portfolio is going to be beta, maybe 85 and then there’s going to be a little bit of the other risk factor in there. The way to capture just the risk factor or try to capture as much of that as you can without beta is to go long/short.

A couple of problems with the long/short is that it takes up space in a portfolio that otherwise would have been allocated to beta so this is a real true allocation to the other risk factor. Secondly, they can be quite expensive to do it that way, not only from a trading standpoint but also from a fee standpoint.

Now, there is a cash component to that and if interest rates are low, you get a lower rate of return of interest rates are higher with the cash component of it, you get a higher rate of return, I don’t want to go to the technical side of it but it’s a way of doing it. I think that more for institutional investors than individual investors, you really would need a very sophisticated individual investor to employ that kind of a fund in there.

Not out of the question, it’s just – if this is what you believe in and you want to have these exposures and can go portfolio, how do you do it? Do you do it long only where you get a lot of beta, whether you do it through long/short where you get only the other risk factors, you're seeking but potentially at a higher cost. There was a technical answer but I hope I answered your question.

**[0:13:18.5] BF:** That’s the perfect answer, thank you.

**[0:13:20.2] CP:** I have a separate question for you. You’re on Barry Rosholt’s Master’s in Business podcast a few years ago and Barry asked you, how much of your time you spend on behavioral coaching? I believe your answer was, 95% of your time is being a behavior coach. Now, you’re a pioneer in low cost, providing low cost advice, what are your thoughts on the price and the value around behavioral coaching?

**[0:13:44.8] RF:** I think that’s pretty much what an adviser does. Like I said, 95%, because the portfolios are out there, the technical side of this is out there. You can divide what we do in the industry between technical and behavioral. The technical stuff is everywhere.

You can go anywhere and get tan asset allocation, a pie chart. One of my friends was telling me, I talk with this adviser and that adviser last week, he’s not a client, he said, everybody has their pie, everybody is selling pie. They’re all selling pie charts, asset allocation models. I thought that was funny.

It’s all out there, it’s pretty much free as you were talking about these balanced portfolios now, we’re becoming popular, that stuff’s free. What isn’t free is a psychologist to help you go through the rough times. A behavioral coach who can help you stay the course as John Bogle would say. That I believe is one of the main reasons why people hire an adviser to help them stay the course. One of my former clients, which are very bright man who got through one of the major law schools.

By the time he was 20 years old, he had graduated from high school, graduated from college and finished law school when he was 20 years old. He hired me because he could not stay the course, he could not maintain his portfolio, he knew what to do, he knew he needed index funds, he knew he needed a fixed allocation to index funds, he got it, he saw it, he just couldn’t do it.

He hired me to have conversations with him and keep him on track and so, I believe this is what the role of most financial advisers is. Once you get past the technical stuff, once you get the accounts setup, once you get to help them with determining whether you should have a trust or you should not have a trust and things like that and do the financial plan. After that, it’s 95% behavioral coaching.

**[0:15:38.6] BF:** That’s a great answer Rick. Now you’ve left the firm that you’re with, Portfolio Solutions, the firm that you’ve built and you have started a new venture called Core-4 Portfolios. So, you’ve built a website that has like you said, the portfolio is out there for free and you’ve now done that explicitly where you put the portfolios online for free, which is great. The other thing that you are offering through the site as far as I can tell is hourly advice.

So that someone could call Rick and get advice from you. The question that I have for you is we were just talking about behavioral coaching. There are some technical aspects to investing as well, what do you expect when people start calling you? What do you expect they’re going to be calling to ask you about?

**[0:16:18.3] RF:** Well it is when they start calling me because my non-compete doesn’t end until the middle of April. So, I set up everything of which I legally can do. I set up my website, I set up what I am going to be doing. I am filing my ADV in the next few weeks down here to it’s become a registered investment adviser. So, I am not one now and I don’t have any clients but the website as you said does have some model portfolios in it.

So, I think that a lot of people are going to be looking for second opinions. In fact I coin this term called portfolio second opinion even though everybody uses that phrase, I am going to be using it on my offering, which is simply call me, pay me a fixed fee to look at your portfolio, give you my recommendations on what you could do to make it better, send you on your way and if you need more help call me back. As simple as that.

I think there is a huge need out there for that. There are people that are doing this but I am not saying you shouldn’t use an adviser if you want to implement your portfolio with an adviser, you can use your current adviser. You just go to them and say, “Hey, here is the portfolio I want to implement” and work with them on it. I also expect to get business from advisers. A lot of financial planners really don’t enjoy the investment portion of what they do and would rather have some expert if you will.

And I hate that, calling myself an expert because nobody is an expert but somebody else help the client with the asset allocation come up with the proper portfolio and then the financial planner helped the client implement it. So, it is not just directly from investors, I expect half of my business to come from advisers in financial planners.

**[0:18:03.5] CP:** Well I guess it would almost be a natural fit too to the whole robo-adviser landscape as well and I am curious, how might you fit in with that and what do you see about for the future of robo-advisers?

**[0:18:14.6] RF:** That’s a good question, yeah. How does my ideas fit in with robo-advisers? It fits in very well. Now what I hope to do once I launched is to work with certain robo-advisers to create these simple Core-4 type portfolios, which would be on their platform and then if investors choose not to do it themselves by buying the funds themselves, they could go to one of these platforms and it would be there and they could use a Core -4 Portfolio, which is already up on one of those platforms.

So, I think it’s good, it gets back to discipline. There are three things and I am going to get off on another topic here but we can talk about it so I will just mention it briefly now. There are three things required for a person to be a good index investor in the long term. There is the philosophy, you have to believe in the low fee, believe in indexing, believe that this is in the best interest, in your best interest so you have the philosophy.

Then there’s strategy, how are you going to use that philosophy for yourself in your own unique situation. Yours is different than mine, it is different from the next person’s. So while philosophy is universal, strategy is personal. So, you have your personal strategy for your need but the third part of that is discipline, how do you maintain it. How do you maintain the strategy, how do you maintain the philosophy and automation?

Automating as much as you can, automating investing, automating rebalancing, automating tax management, automating as much as you can through a balanced fund or through a robo-adviser or maybe by hiring an adviser is the way to go. Every study has shown that if you can give it to somebody else to do it and you forget about it and it’s automated, you have a much higher probability of maintaining it. So that’s where our robo-advisers and the advisers and the balanced fund ideas come in.

**[0:20:05.3] BF:** I love that philosophy, strategy, discipline I think that’s great. Now kind of on that topic, there are still a ton of people, I mean we’re talking what indexing like everybody is doing it we are taking that for granted but the reality is the majority of investment, of assets anyway are still actively managed at least in Canada. I believe it is still the same in the US as well. For those people who have not started indexing yet, what do you think it takes?

**[0:20:28.5] RF:** Repetition. I think you need to see something about a hundred times and on the 101st time, you have enlightenment. So, people can look at the word index funds, they can read about it, they can listen to this podcast, that might be a little bit overboard listening to this podcast but because people who are only really interested in it are going to probably listen but they’ve got to be exposed to it. They’ve got to see it, they’ve got to hear it, somebody has to say it on the television.

They have to read about it on the internet. It is about a 100 times they need to be exposed to the word indexing outperforms active management before they actually take a look at it to the point where they become enlightened. So, you just need more repetition. The difference between Canada and the US is we had indexing here in the United States for a long time and it has been promoted by Vanguard, a mutual benefit company.

Up in Canada, you didn’t have a Vanguard. You do now but you didn’t at the time so you had no mutual benefit company promoting the idea. You had for profit companies promoting active management and you only had a few advisers promoting indexing and even then, that was relatively recent. So, you just need more, more in the media, more podcast, more books, more articles, just more, more, more, more saying the same thing over and over and over again.

Only a little bit differently. I remember having a conversation with Jonathan Clemens who was a journalist down here and we agreed that nothing new has happened in this industry in 25 years but we continually figured out new ways of saying something to make it sound new and that’s what you just got to be repetitive, repetitive, repetitive, repetitive and they will come.

**[0:22:14.8] CP:** Well we are doing our part Rick so let’s hope we are making a difference.

**[0:22:19.1] BF:** I have a separate question for you. So, let’s assume you got way more money than you’ll ever need and that person comes to you to figure out what their asset allocation should be. I mean we all know Larry Swedroe. His rule of thumb is you take on the amount of risk that you’re able, willing and need to take on. How do you coach someone that has far more assets than they’ll ever need in term of their equity exposure?

**[0:22:40.5] RF:** Right, so the first thing I’d do is say, “How much do you need and how much are you going to pass on to the next generation?” and by you I mean you and your spouse and how much are going to go to your children or your grandchildren, are going to go to charity or wherever it is going to go later on. What do you need for you until you live to say 100 or your spouse lives to 100 and then what do you give into the next generation?

And they go, “Well okay, I need a million dollars for me and then 10 million or 20 million I’ve got left is going to go onto somebody else” fine. What should the asset allocation be of the million dollars that you need for yourself? So, let us work on that and we work on an asset allocation for the million dollars. Then we say, “Now what asset allocation would you recommend for your children or your grandchildren who aren’t going to need the money for 30 years, what do you think we should do there?”

We come up with a separate asset allocation. It might be 60% equity and the one for ourselves might be 40% or 30 or maybe even 20 or some number. All right so then we put the two together. Now therefore, if a million dollars is for you and it’s at this allocation and 10 million dollars is for your children and it’s at that allocation then overall, what should your asset allocation be? And they say, “Well they’re probably 55 equity 45 bonds” good, done, finished, next question.

**[0:23:53.3] BF:** Solid, rock solid answer. One of the last questions we want to ask you Rick is about John Bogle who recently passed away unfortunately. Now you mentioned the impact of Vanguard and actually as a little side note, I have never heard anyone describe the importance of Vanguard in the US pushing it forward index funds and that being a reason that it did not happen the same way in Canada. I mean I guess people eluded to that way in the past but describing explicitly that way.

And attributing to Vanguard I thought that was fascinating, so Bogle obviously had a big impact on the industry. You have interviewed him, I believe you knew him. I thought it would be great if you could maybe just speak a little bit about him as a person and how he changed the financial services industry.

**[0:24:33.5] RF:** Oh wow, that is a big order. Well of course he was an icon, although he is a very unassuming person meaning that he didn’t want to take any credit. I mean he took credit, he loved the spotlight and all of that but he was a very simple man really personally in his personal life and it is almost the statue that they built for him at Vanguard, he laughs at it. It’s almost like John Bogle said, “Everybody should be doing this. Why isn’t everyone trying to help everyone else? It’s not me, John Bogle, everybody should be helping everybody else that’s why we exist on this earth. So, don’t give me any credit for what I did, everybody should be trying to help” and that’s the way he was.

He would go to great lengths to shake people’s hands and remember their names and talk with them and answer letters. I have two or three handwritten letters from him. I had a little card every time I did something or sent him something, he would send a handwritten letter back. I mean he was just a unique individual and he was believable and trust worthy and committed. He knew what he was going to say before he said it. He’s done more for individual investors worldwide than anybody in the last 50 years since the first index fund came out.

So I can only hold a Bic lighter, you know when you go to a concert, well I am dating myself, if you go to a concert and there’s the act on the stage and it’s just absolutely phenomenal and all you can do is at the end of the concert hold up your Bic lighter. Of course, now we hold up our iPhones and you know I am one of the people in the audience holding up my iPhone, you know what I am saying? I believe in what you do and I am a disciple, I am a follower, I will do what I can to help promote what you started and away we go.

I honestly can’t say much more about the man. He did so much for me personally, he changed my life through changing my career and a great man. He will be remembered for a long time.

**[0:26:34.2] BF:** Very well said.

**[0:26:35.7] CP:** Yeah and it is interesting Rick because as I said earlier, I have been following you for years so that trickled down as come through to our firm, you know the next generation advisers have been and the others here kind of trickle through the whole system. So, it is incredible to see the impact around the world. I mean speaking around the world, a few weeks ago we interviewed Robin Powell who I know you know and who interviewed you I believe for his documentary.

In our interview he made the case that journalists have some responsibility to publish, not simply to publish the story about stock picking but actually publish more stories about the truth about how markets work and what the evidence is. Do you agree with that assessment?

**[0:27:15.4] RF:** To a point, a journalist works for a company. The company has to appease their advertising clients. The advertising clients if they are big, large, actively managed funds or hedge funds or whomever they are, the company has a right to ask its journalists to mention those companies to at least not say things bad about those companies. They have the right to do that. The journalist is not independent. They are not a freelancer.

They work for that company so if the company wants the journalist to play down what the journalist may personally believe and play up what brings the company that they work for, advertising dollars I think they have a right to do that.

**[0:28:00.5] BF:** It is a great way of looking at it.

**[0:28:02.7] RF:** By the way, if a journalist has a problem with that, then they needed to leave the company they’re working for and find someone, find another company that may not have that restrictive policy or go out on their own and freelance.

If their career is like me, I worked for a brokerage firm for 10 years and I didn’t like what I was supposed to be telling my clients, what the company really wanted me to tell my clients then I get up and left and started my own company. I think a journalist, if they’re professional and they got to follow their heart rather than their paycheck, they could – they would do that as well.

**[0:28:37.0] BF:** Rick, you’ve written seven books, right?

**[0:28:41.1] RF:** I think so, sounds right.

**[0:28:44.0] BF:** Working on the eighth I guess, you built a great firm, which you now left, you got another venture going, you’ve changed probably many thousands of investor’s lives probably in the tens of thousands with all of the writing that you’ve done. The question that I have for you to finish is with all the things that you’ve accomplished so far in your life and now looking ahead, how do you define success for yourself going forward?

**[0:29:05.7] RF:** I just want to continue to be part of the conversation and that was a quote that Jonathan Clement said to me when I did a podcast with him a couple of months ago. Jonathan doesn’t need to work anymore; I don’t need to work anymore but I just want to continue to be part of the conversation I have. It seems like I have more to say now at age 60, almost 61 than I did when I was 40.

I believe that keeping things simple, explaining things so that people can understand them, taking complex ideas and breaking them down into easy bits and letting people comprehend it is important. There’s a quote that I won’t take credit for but I use it all the time. The truth must be repeated over and over again because lives are constantly being told around it.

I am just going to continue to repeat the truth over and over again and that’s my contribution.

**[0:30:00.1] BF:** Well Rick, I can’t tell you how much we appreciate you giving us the time to come in the podcast.

**[0:30:04.4] CP:** Rick, thanks for being part of our conversation, for all you’ve done to change how we are helping people in our part of the world.

**[0:30:11.2] RF:** Well, thank you for inviting me.

**[0:30:12.9] CP:** All right, take care.

**[0:30:13.3] RF:** Bye.

[END]

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