The Rational Reminder Podcast - EPISODE 36

[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. Welcome to episode 34 of the Rational Reminder podcast.

[0:00:15.5] Cameron Passmore: Yes, Ben's got a bit of a cold from his kids.

[0:00:17.6] BF: Yeah, can't stop getting sick. The kids go to school and they come back and everyone's sick again and then they get better and then they go back to school. A bit of a long episode today, we talked about the usual kind of stuff we talk about in a normal episode we also did a bit of a deep dive on well, two things in the end, we talked quite a bit about asset location and then we also talked at the end quite a bit about the new ETF model portfolios that we've proposed.

[0:00:41.0] CP: Then we covered off a couple of podcasts that we've been listening to with some interesting tidbits for investors, some good information there about the industry, about the evolution of the industry, about working with the clients. I think there's lots of good stuff in there but we'll make this short because the episode is a little bit long.

[0:00:55.5] BF: All right, here you go.

[INTERVIEW]

[0:01:02.7] BF: Welcome to Episode 36 of the Rational Reminder Podcast. As promised, today, we're going to roll out our new ETF model portfolios and it's only two new ETF's compared to a couch potato type portfolio that you might be familiar with. Nothing too revolutionary but a meaningful difference.

[0:01:19.9] CP: What's the main reason on why you wanted to come up with this?

[0:01:21.7] BF: Well, we talked about it last time. We want to continue talking about factors and the importance of small cap and value tail and taking independent price to risk in portfolios but we wanted to scale back talking about dimensional based on the feedback we've been getting.

[0:01:34.3] CP: Yeah, this gives some listeners who want to do this on their own, some tools to go ahead and do it.

[0:01:38.2] BF: Yeah, we're not just talking about this is what we do, it's actually, you can do this. You can do it. My opinion and we'll talk more about this as we jump into it but if anyone's willing to slice up a portfolio for tax efficiency purposes, someone's going to go buy US ETF's on their RSP to pay less withholding tax, they should absolutely be looking at adding smoke cap in value.

[0:01:57.1] CP: For sure.

[0:01:57.6] BF: If someone values simplicity and they're not buying US Lit ETF's for tax efficiency then maybe they shouldn't worry as much about the small cap in value. Anyway, we'll jump more into that a bit later, we have a few things to go over before we get there. One of the big ones that I wanted to start with was some new thoughts on asset location, which we talked about in one of our earliest episodes through reading and research and modeling and all that kind of stuff.

We have come to the understanding that when someone takes their portfolio and puts all of their bonds in their RSP, that's kind of the generally accepted asset location philosophy and it does look pretty good if you model a portfolio that's done that, all the bonds in the RSP compared to a regular balanced portfolio with the same asset mix across all that counts, putting all the bonds in the RSP, it will give you a better result, which is interesting.

[0:02:46.7] CP: As time period specific, right? You're talking about falling straight environment?

[0:02:50.6] BF: No, it's not even that. It's even cooler than that because the pre-tax asset allocation, which is what people usually focus on doesn't matter. The only thing that matters to your returns is your after tax asset allocation. If you go and put all of your bonds in your RSP, the after tax value of your RSP, depending on what your tax rate is less than whatever's in your account, for sure.

[0:03:10.6] CP: Depending on your tax bracket, unless your tax bracket's 0%, it's going to be less, some amount less.

[0:03:15.6] BF: 53.53% or less than what's actually in the account. Now, because of that and because your after tax asset allocation is the only thing that matters to your returns, if you put all your bonds in your RSP, you end up with a more aggressive portfolio.

[0:03:29.6] CP: Because you have to grind down the allocation to fixed income volume marginal tax rate.

[0:03:34.2] BF: You have to. By your expected future marginal tax rate.

[0:03:36.7] CP: Right, if you're saying a 50 50 portfolio overall.

[0:03:39.8] BF: Well, I did an example so we could talk about it. If you took a 60 40 portfolio worth a million dollars, one million dollar portfolio with a 60 40 pretax asset allocation. If we say there's a $400,000 RSP, the $600,000 taxable account, we puppet all the bonds in the RSP. That looks like aa 60 40 portfolio pre-tax.

But if we assume the highest marginal tax rate, in the future, then the after tax asset allocation that portfolio is closer to 75% equities. Now, if we go and put a portfolio with the same asset mixed across all the accounts, the same as 60 40 portfolio in the RSP and in the taxable account, then our pre and advertised asset allocations is the same.

It's a true 60 40 portfolio pre and after tax if you have the same mix in all accounts because you're burning down in the RSP. Each asset class proportionally based on the expected future tax rate. If we go and compare these two portfolios now, we're really comparing a 60 40 portfolio to a 75 25 portfolio.

Which one's going to do better on average?

[0:04:39.0] CP: 75 25, you would it to do better.

[0:04:40.6] BF: Because it's a more aggressive portfolio. Okay, that's interesting, what happens if we start thinking what asset allocation or asset location and allocation using after tax asset allocation as the starting point.

Instead of focusing on pre tax asset allocation and trying to optimize the locations.

[0:04:57.9] CP: I can hear all the listeners collectively scratching their heads and wondering, what is going on here?

[0:05:02.1] BF: I don't know what else to say.

[0:05:03.3] CP: I know. But we scratched our heads on this one as well for the past week or so, especially you.

[0:05:07.3] BF: Well, it's fascinating. Anyway, if we control for after tax asset allocation, that means that we would not be putting all of the bonds in the RSP. I guess if we needed a 60 40 portfolio, yeah, we couldn't put all the bonds in the RSP in our one million dollar, $600,000 taxable 400,000 RSP example because we wouldn't end up with a 60 40 after tax asset allocation. We have this little optimizer tool that we built a while ago to model this, to model asset location and in that tool, we can choose, do you control for pretax or after tax asset allocation?

We control for pre tax, we get the result we've been talking about, where the optimizer puts all of the bonds in the RSP. But if you instead control for the after tax asset allocation, the optimizer will put mostly international stocks as much as possible in the RSP.

[0:05:56.3] CP: Because?

[0:05:56.6] BF: Well, they've got the highest expected return and the assumptions that we use in the model and this kind of jives with –

[0:06:01.8] CP: Withholding tax as well? What's also going on too.

[0:06:05.2] BF: Withholding tax, it would be higher. That would be a reason not to have the international stocks in the RSP. Anyway, that finding of control, if you control for the after tax asset allocation that international stocks end up in the RSP, that jives with a research paper that was in the journal of finance in 2004, which has this really interesting proof, like it's a mathematical proof.

Showing that the only thing that matters for the optimal asset location is the yield. The variable growth rate on asset does not matter, which I still haven't fully wrapped my head around but –

[0:06:34.5] CP: You tell me what cash flow.

[0:06:35.9] BF: Taxable cash distributions on price. Their conclusion of the paper, one of their conclusions in the paper was that the highest yielding asset should go in your tax free accounts. That's actually interesting that paper too, they don't differentiate much between tax free and tax deferred. They introduced the idea of the tax deferred account, we only care about the after tax amount.

[0:06:55.7] CP: That's the RSP? Tax free as a TFSA.

[0:06:57.9] BF: That's right. If we take the RSP and only about the after tax amount that all of a sudden the after tax amount in the RSP is really like a TFSA. Now we've got the RSP and TFSA are both after tax or both tax free accounts if we're only thinking about the after tax balance off the RSP.

Anyway, this 2004 research paper suggests, the highest yielding asset should go in the tax free account whether that's RSP or TFSA and the reason that's interesting is because when that paper was written in 2004, the highest yielding asset was bonds. But now in 2019, with the yields where they are, international stocks are yielding well above bonds.

[0:07:32.5] CP: What's your bottom line key takeaway after noodling on this for over a week? In the normal retail world?

[0:07:38.9] BF: Well, I think one of the major takeaways is that asset location is way more complicated than people think it is and people following the common logic of putting all of your bonds in the RSP or as much bonds as possible in the RSP, you're truly ending up with a more aggressive portfolio than you think that you have.

Now, I've seen arguments online that maybe that's a good idea, maybe this is a good way to –

[0:08:01.5] CP: To fool yourself.

[0:08:02.4] BF: Arbitrage your own behavior I guess.

[0:08:04.1] CP: Behavior arbitrage, that's interesting. You can have more aggressive portfolio without worrying about it but is that the prudent thing to do? Even the pre tax, bonds and portfolio is a dampener of volatility. Still other pre tax and amount of bonds in your overall portfolio, which will cause a portfolio overall to be less volatile.

[0:08:21.2] BF: Pre tax.

[0:08:21.9] CP: Pre tax for sure. No one thinks about after tax basis as they look at their statements month in, month out.

[0:08:27.7] BF: Which is a problem because the only thing that matters to your outcome is your after tax asset allocation.

[0:08:32.5] CP: I get that. I'm just saying, from a behavior, it get someone who is whatever, 10, 20, 30 years areaway from retirement to get them there in a way they're going to behave well, they look at the real world value of their portfolio.

[0:08:42.5] BF: That is the strongest argument that I can find for trying to optimize for asset location. Although, I guess following that logic, you'd be doing it in a flawed way intentionally to trick yourself into having a more aggressive portfolio.

[0:08:54.9] CP: For sure, absolutely.

[0:08:56.7] BF: Which means there could be a better way to have a more aggressive portfolio while having an actually after tax optimal asset location strategy.

[0:09:04.1] CP: Go find me someone that might have a half million RSP. Really think, it's only 250, $300,000, nobody thinks that way.

[0:09:10.8] BF: Definitely not, which his exactly the problem.

[0:09:12.5] CP: Right.

[0:09:14.1] BF: I haven't heard many people talk about this. Most people talk about bonds in the RSP because you're going to pay less tax later, which is true but when you start thinking about the pre tax versus after tax, the only reason that you're paying less tax later by putting bonds in the RSP is because you have less money.

[0:09:26.8] CP: Exactly. The pre tax portion didn't grow as much, which means your portion didn't grow as much and neither did the governments.

[0:09:32.0] BF: Fascinating.

[0:09:32.7] CP: Yup.

BF: I think that like I said, the main takeaway is that asset location, trying to optimize that is way more complicated than most people think and to have a truly optimal asset location, I think that it ends up being meaningfully different than what people currently view as an optimal asset location strategy.

[0:09:51.1] CP: You then make a good argument to have the same asset mix across all your portfolios and forget about asset location? The way it truly reflects, which are risk preferences are?

[0:10:00.0] BF: Yeah. I mean, one of the big things with the 2004 research paper that I mentioned is that proof that shows that you're better off having the bonds and the tax free accounts like I said before. It relies on bond yields being higher than dividend yields. As soon as that switches, the whole thing switches but then it also relies on tax rates.

You've got to make sure that the tax rate on yield is higher than the tax rate on capital gains. Now, those are both things that could change.

[0:10:25.5] CP: Right.

[0:10:26.0] BF: Yields can change, tax rates can change. That's kind of when we formed our direction on having a balanced mix across all accounts many years ago, when we made that decision, because we decided that if it happens that yields change and all of a sudden you've got now a sub optimal asset location strategy like we've seen with bond yields coming down, making stock yields relatively high, now all of a sudden, you're stuck.

If you had all off your bonds in one account and the big capital gains in your international stocks in another account, now you've got a sub optimal asset location strategy. What do you do? Do you change? Do you stay with the sub optimal strategy? What if tax rates change? All these different variables, that's why we decided to go bounce across all accounts, which is for me, this whole deep dive in asset location just reaffirm that for me because at least, at the very least, you know what your asset mix is. If you're trying to optimize by putting everything in the RSP for example, you don't really know what your asset mix is.

[0:11:21.1] CP: Or to know what it is, you have to do the math.

[0:11:23.3] BF: But you don't know what your future tax rate is, you don't know what your future income is, you don't know if tax rates are going to be. How do you truly build an optimal asset location strategy?

[0:11:29.2] CP: This is something that I continue to think a fair amount about, but our opinion as of now has not changed. What do you make it a performance so far this year?

[0:11:37.7] BF: I don't want to say it's not unexpected because that's a tough thing to say but you know, markets go down, they come back up, they could have kept going down, of course, which is why I say it's a hard thing to say.

[0:11:47.0] CP: That's why you have to stay in your seat where you said it so many times. 60 40 portfolio, drop down five points on the percent last year and it's now back above where it was in January of 2018. All of last year's losses and a little bit more have been made back so far this year.

[0:12:02.2] BF: Yapp, and small cap and value have been on a tear so far this year.

[0:12:04.7] CP: Small cap value's opening 17% year to date in the US.

[0:12:08.7] BF: IJR is just small cap market I think, IJS is small value. It's under new model portfolios. Yeah, like you said, staying in your seat is important.

[0:12:16.4] CP: Anything else to add to the model portfolios?

[0:12:18.3] BF: I think we'll come back to that after we cover some more of – I know you had a couple of things you wanted to go over?

[0:12:22.9] CP: Yeah, I was reading Fivel's book called *Team Of Teams* written by the US general Stanley McCrystal. He's a fang forced our general, best known for being commander of the special operations unit in Afghanistan and it's a really interesting book about how management has changed over the years. I thought, when I was reading this morning, he talked about complex versus complicated.

The title of his book is Team of Teams: New Rules for Engagement For a Complex World. Maybe you cover this in your engineering background, I don't know. But I thought it was interesting how we contrasted things that are complicated versus things that are complex.

Example he gave was, a car engine is complicated, all kinds of different moving parts that have been engineered over time, we kind of know what the output's going to be, it's going to propel your car forward. Complicated he says, more like a chess game with hundreds of thousands of thousands, if not millions of different outcomes and you don't know how other parties in this game are going to react depending on new information.

[0:13:21.4] BF: Yeah, interesting, it's almost like intricate versus complex adaptive. Those words work better in my brain for the comparison. The car engine is intricate, a chess game or the stock market are complex adaptive systems.

[0:13:34.3] CP: At the face level chess is simple people don't understand the moves you can make. You just don't know how other participants are going to make them. You start thinking about our world of finance and try to predict markets and what not, you think of you might see something's being obvious but you don't know how the market's going to read into certain pieces of information via the trade wars with China be it the steel Charis, whatever it might be.

You don't know how all the participants are going to react to it.

[0:14:01.5] BF: Exactly. That's a complex adaptive and it's this never ending cycle of participant one, trying to think about what part has been two is going to think who is trying to think about what participant one is going to think. They're going back and forth in this cycle but nobody can know what everybody else is thinking.

[0:14:17.2] CP: But it's happening at two levels, right? Because we're at the asset pricing level as investors. But down on the ground, you have companies doing the same thing with their competitors. You go out this dog fight at two levels, the companies competing in the market place, you have asset prices or traders, brokers competing at the shared price level.

But yet, you have retail investors and one of control of the portfolio is trying to impart their beliefs on their portfolios, thinking about how stock prices will react to how companies will react. I mean, you think about that way, it's kind of bonkers thinking you can control this crazy elaborate complicated complex system.

[0:14:52.4] BF: Which is exactly what show up in the data. That's why people don't beat the market consistently. He gave one little stab in the book saying, "November 2007 survey a 45,000," I'm quoting here. "Economic data series for less than a one and 500 chance of an economic slowdown, a severe one that happened in 2008 and hides it, it might appear pretty obvious and we all know about the big short and what not.

It was not obvious to a lot of people at the time."

[0:15:16.2] CP: Yeah, it's interesting.

[0:15:18.0] BF: I always come back that data point in my head when we talked about stuff like this of the stat on the performance of the SMP 500 over the last 10 years being basically statistically impossible. Based on the data that we had prior to that actual outcome happening.

Stuff that just cannot be – can't be predicted.

[0:15:32.7] CP: Another thing I listened to this weekend, I wasn't too, the Michael Kit's Financial Advisor Success podcast, which I know our listeners that isn't necessarily their target, kind of podcast but it is for us. He was interviewing Mitch Anthony who is a well-known author in a world, key note speaker and cofounder, of what's called Life Centered Planners and another advisory from the US. He was talking about the benefits that he saw working with an advisor.

Which I thought was kind of neat. Point that he gave, one is, the organization kind of the corporate memory consistency of experience you have with the firm. Number two is accountability and he thought this was the biggest one. He says, "Why do so many people have exercise coaches and personal trainers and whatnot?"

He's not necessarily going to drive themselves as hard as they would otherwise. Another one is objectivity, number four, proactivity, number five is education and number six is partnership. He says, these are all the reasons that he thinks why many people choose to work with an advisor when you add that up.

That's what should lead to a good investment experience.

[0:16:32.8] BF: Yeah, that's interesting. People often will say stuff to me whether it's in person during a conversation or online but people will often say stuff like, "Well, I can just go and get a plan from a fee only planner for $2,000."

[0:16:47.4] CP: And just buy an index fund.

[0:16:48.6] BF: Buy an index fund. What do you guys do? It's hard to – I don't know if we've talked about this before in the podcast but it's hard to objectify that because a lot of the value in what we do is in the eyes of the clients that are receiving the service and the value could be extremely different from one person to the next but I think that list that you read captures a lot of it.

[0:17:09.5] CP: The point of this is not to be sales-y. The point is, if you are doing it on your own, which is totally fine, just make sure you've got all these things accounted for as you take care of your things.

[0:17:19.5] BF: Well you won't. I'm not saying like again.

[0:17:22.8] CP: You can take care of a lot of it, you put certain rules in place, you can make yourself accountable. If you know you're going to rebalance every month or every quarter, whatever it might be. With the rules in place, are you objective, I guess you can be as objective as you can, you got to do the work, education, you do the work, have to do the research. Just to be aware of what you're giving up if you don't have your own advisor.

[0:17:39.7] BF: I guess, what does it take to truly be on top of all of those things? You definitely don't get continuity. One of the ones we intervened someone named Dr. Moira Somers for a future episode and one of the things that she talked about was the continuity piece where in a lot of cases, she consults with Hanover's family.

She's a neuropsychologist I believe and one of the things that she sees is that there will be one person in a couple. I would wager that it is probably the male in most cases is totally on top of the stuff and maybe they do check all of those boxes that you just listed but if something happens to them then their spouse ends up in a tough situation and that is something that I think is pretty tough to replicate I guess unless everything is completely automated.

[0:18:27.1] CP: How many times have people said to you, "Well I don't quite see you why I need you" yet their affairs aren't all perfectly buttoned down.

[0:18:33.4] BF: Yeah, I mean I have talked to people in many cases that will say, "Yeah I don't understand why I would pay for advice," and then you start digging into the situation and it's like they have maximum hours peace out in 10 years and –

[0:18:43.0] CP: While I cast I don't know how to deploy it.

[0:18:45.0] BF: Sitting on all this cash.

[0:18:45.9] CP: Should I buy a condo in Toronto? Yeah, I should get to my will someday.

[0:18:49.4] BF: I am not sure about asset mix.

[0:18:51.0] CP: Don't have beneficiaries named.

[0:18:52.6] BF: Anyway, I want to reiterate, it is not a knock against do it yourself investing but it is interesting to see the contrast between the people who say to us, "Well why would we pay you?" I had somebody actually recently say to me that they asked the question, "How do you guys make any money because you give away all of the knowledge for free?" it's an interesting question but just because we are giving away the knowledge doesn't mean that everyone is going to go and take all of the knowledge we have and perfectly implement it.

[0:19:14.6] CP: Strategy is easy, execution is hard. It's just like diet, I mean we all know about diet forever. How come everyone isn't a chiseled specimen of a human? It is just not easy. Also another good quote I thought was neat, if something is measurable it will become a commodity.

[0:19:30.2] BF: Yeah that is interesting, really interesting.

[0:19:32.1] CP: So I know you saw those articles well on CNBC talking about the former bond king, Bill Gross.

[0:19:37.7] BF: Well it's just funny. It should be a comic.

[0:19:40.7] CP: So Bill Gross, famous bond manager at PIMCO, he was there for 40 plus years. He left after a pretty big scrap in 2014 and joined the Janice Henderson Group in 2014. They gave him a new fund, the Global Unconstrained Bond fund, which sounds pretty cool. Quickly raised about a couple billion dollars. I only made any money in the time and it is now dribbled down to $900 million or so and he finally announces his retirement.

The next month it lost another $200 million in assets and he's came out now on is it a Bloomberg article citing CNBC or probably vice versa talking about how it is much harder to find missed prices in the marketplace. So here is this guy who tightened himself for years of being the guy who beat the market. People loaded him up like when he was at PIMCO he managed 270 billion dollar fund, made millions of dollars for himself and I guess investors and now he's had his run.

He says, "It is pretty hard, you can't do this on your own." People can't beat the market there's no more alpha left.

[0:20:33.7] BF: There's always that amazing question of was he lucky or was he skilled and I think one of the most challenging things about that question is that just because he is smart, which he is and has a great background and all of that kind of stuff doesn't necessarily mean that he is a relatively skilled fund manager.

[0:20:50.5] CP: He even said that. Did you watch the interview?

[0:20:52.2] BF: I did not.

[0:20:52.7] CP: So he talked about how in their fund they basically bought tenured treasures and let them roll down every year, rolled down to nine years. Go back to 10 and then roll down again to nine each year so it's interest rates fell over the decade then made a fortune. He said it was basically easy and here you go, you have a star manager retire. Money poured in when he went to Janice and now people leaving in drove.

So we have never been fans of banking on star managers obviously but it is a bit of a slap in the face I would think for people. So now they have rebranded the fund, given it a new name.

[0:21:21.0] BF: Yep, stuff like that is fascinating.

[0:21:22.8] CP: So you listened to that last podcast that we have been talking about, one on invest like the best, the Patrick O'Shaughnessy interview with Michael Kitces?

[0:21:29.9] BF: Yeah, that was a good one too. He gave a history of the financial advice business and how it's evolved into what it is today.

[0:21:40.9] CP: It's crazy to think of all those decades where you had stock brokers overpaid fixed commission rates of roughly one percent of the trade on the buyer that sells. That is where the stock brokerage business came from.

[0:21:52.0] BF: Yeah and then fixed commissions go away so you have variable commissions so firms start competing on how much commission they're charging and then you get to discount brokerage and then advisors who are wanting to sell advice types services, they start getting away from stocks because now that is a commodity but then all of a sudden, mutual funds this new thing and so you need someone to pick your mutual funds for you and now that is a commodity.

[0:22:11.8] CP: But they went to mutual funds because of the trailer, right? They have followed the money. I mean Canada was. I came into the business when trailers first came out and the DSC fund was announced by McKenzie Financial. It was, what was his name? Jim something at McKenzie. He created the differed sales charts. So you sold the fund and you got a four, five or 6% commission. So people started migrating towards mutual funds.

So all of a sudden, you became a manager selector person and then as more and more technology came into play and more and more robo-advisors and all the price competition. Michael Kitces makes the argument that people had to add more value in the vertical chain. So whoever is closer to the client keeps the margin and squeezes everything up above. So he says the whole migration towards indexing in his opinion is that was based more on cost not on the fact that indexing makes any sense.

[0:22:58.1] BF: I thought that was fascinating. A fascinating point.

[0:23:00.2] CP: Right? So I mean with us it is a combination of the two right? For sure, we absolutely believe in the philosophy so that is not the norm. Most people went there because they want to keep their marginal decline, 75 or a 100 basis points fee and shrink all the cost up above.

[0:23:14.2] BF: We have even seen that from – I had talked to people who not even going to index funds. Just had an advisor that went from commission based to fee based but the clients fee didn't changed because the advisor ended up charging more for their fee based service than they were receiving as a trailing commission when they were one the commission based structure. You always follow the money, it is totally true.

[0:23:33.6] CP: Well I have been amazed, I mean some of the US advisors that Michael Kitces introduce in his podcast has charged unbelievable fee levels like somewhere around 1.5, 1.75% in the first half million dollars.

[0:23:44.8] BF: It is crazy to me. I think we live in this world where we're very much influenced by I guess the Coach Potato blog really, which is been one of the main sources of information for people wanting to learn about index investing and it is a very fee focused blog in general and I think that translates into the people that we end up talking to in a lot of cases.

[0:24:03.8] CP: I also thought it was neat how he broke down the US market basically saying we know where the money is and whose got the liquid money that can be invested. He says most of the investment advisor market place is competing for 7% of the population, even less if you have a high minimum. So many firms of high minimum say $1 million were even in the smaller part of the population at 7% but his trend he says if he looks out 50 meters plus.

He sees a huge trend in the US where so many people have liquid assets but they are in their 401(k). So the group, panging group RSP type plans. So they have large assets but not that can be managed by an advisor. So he sees an opportunity to charge people who have cash flow but not liquid accessible assets. So to start charging them one to two percent of income will save a million dollars in your 401(k) and you make a $100,000 a year.

Go to place and pay a percentage of that taxable income each year for planning services just because there is a whole swath of the marketplace in that situation in the US.

[0:25:04.0] BF: It's interesting, that's what the firm financial engines. They ended up merging with was it Edelman?

[0:25:09.7] CP: Yep.

[0:25:10.2] BF: In the US and so now that is an REA firm, which is kind of similar to what we are that also has alarm that can deal with the 401(k).

[0:25:17.9] CP: Massive 401(k) like it's –

[0:25:20.2] BF: I don't know what the assets are, it's big though.

[0:25:21.6] CP: It is basically like a 170 billion or something dollars.

[0:25:24.3] BF: Yeah.

[0:25:24.9] CP: I thought that is a neat model you can see that coming forward. He is a big fan of AUM, which we are. We charge percentages of assets. So he says for all of those six things that we talked about earlier from Mitch Anthony, is that his name? Did I get that wrong? Yeah, Mitch Anthony, so all of those things it does take a certain amount of reoccurring revenue to deliver that kind of platform but he sees a market place for people who don't have those assets to pay one or 2% of income.

[0:25:49.4] BF: Yeah, that's interesting. Definitely not something that we'd looked at actually implementing at all.

[0:25:53.7] CP: I am not even sure that that kind of market place is here because the 401(k) in the US I think is much bigger but I could be wrong than a group RSP.

[0:26:00.2] BF: We have probably turned away, people who are interested in working with us based on their assets regardless of what their income is.

[0:26:05.6] CP: Right, well because we have other people coming to the door of assets so it is kind of supply and demand, right?

[0:26:11.0] BF: But we charge on assets, we could charge on income. We'd probably turn, yeah I don't know, interesting. Okay, so we've gone on a few things here but we do want to talk a little bit about the ETF model portfolios. So we looked at a lot of different ETF's as candidates for inclusion in the models and it is not easy to find ETF's that truly offer exposure to the factors. So here we go, talking about factors again.

I see people rolling their eyes but the factors that we want to target in portfolios are the market, which you can get with a regular cap weight at index fund but also size, which is smaller stocks and also value, which is relatively cheap stocks and also profitability. So you control for size and relative price so small cap value type stocks, you can then control for profitability to find the stocks with higher expected returns and exclude stocks with lower expected returns.

The prime example of that exclusion being small cap growth stocks with low profitability. Now the challenge is, if you as an ETF investor go out and say, "Okay, well I want small cap exposure." I don't know what percent, 90% of the small cap products are small cap universe.

[0:27:20.2] CP: With no exclusions.

[0:27:21.2] BF: No exclusions, so you go and get all of the small cap stocks but I mention the exclusion of small cap growth of low profitability. That segment of small cap stocks completely ruins the size premium and that has been documented in many different areas. I think my favorite paper on that subject is AQR just because the title is hilarious but the paper was called "size matters if you control your drunk" and they are referring to small cap gross talks with low profitability as junk.

And they are arguing that small cap, there is a good reason to overweight small cap in the portfolio but if you say you have the junkie small caps then there's no point. So you got to control for the as they call it junk.

[0:28:01.8] CP: So what did you decide to go for in terms of tools?

[0:28:04.4] BF: You have to go small cap value. A small cap value ETF and unfortunately, the only geographic region that you could get that for is US and as far as my research found, there are not small cap value funds for Canadian or international stocks. So you look at like in Canada, iShares has a Canadian small cap ETF, great but it's like a third in small cap growth stocks. So there is no point into having that in the portfolio.

You are just increasing your cost, increasing your portfolio turnover, increasing complexity for no benefit because of the small cap growth. International again, there's nothing. Vanguard has this beautiful product called VSS, which is Global XUS small cap but again, it is just small cap. So it's got a good chunk in small cap growth, there is no point in including it. You are just going to get all the bad that comes with fact hilting, which is slightly higher turnover with more complexity.

But you are going to get none of the good of the size premium and then once we get into, "Okay we want a small cap value ETF for US stocks, even that's not easy. So you start getting into how is that small cap value index defined anyway, without going through all the details. We ended up taking IJS, which is the iShares S&P 600 value ETF and we went with that one because the S&P does their indexes by committee. They do it by committee and they have selection criteria.

So they have tests for financial robust list and stuff like that where they are not going to include a small cap stock that is about to go under and the interesting thing about that is that because they are screening a little bit to find stocks for inclusion, when you run the regression on IJS, it has long term and statistically significant exposure to the profitability factor, which is fascinating because it is not a factor fund.

[0:29:41.5] CP: That may not be their intention either like it is un-intending positive consequence.

[0:29:44.9] BF: It is definitely not their intention. They are not targeting the profitability factor. They'd probably be charging the higher fee if they were but just by nature of the way that S&P is creating that small cap value index, you end up with profitability exposure. Now it is not going to stay there forever, maybe not because they are not targeting it but as the index is structured now and going back like IJS –

[0:30:01.8] CP: They might think it is adding more equality to the portfolio where it is actually getting you a better risk exposure.

[0:30:06.6] BF: Yeah, well it ends up being the same kind of thing. So I thought that was really interesting and we started looking at other small cap value index. It is like the Russell 2000 Value. It's just fascinating. Depending on how you are comparing them, Russell 2000 Value has got more securities, it's got a smaller cap, average capitalization, it's got a deeper value exposure. So you start thinking, "Okay maybe we want a Russell 2000 value ETF."

But the problem that you run into with a Russell indexes is well, they don't have any exclusions so you don't end up with that profitability tilt and you probably end up with some junk as AQR would call it but the bigger problem with Russell index is that they're purely quantitative for inclusion. So that's like as long as it meets the capitalization requirements to be in the bottom 2000.

[0:30:52.2] CP: Of the top 3000.

[0:30:53.3] BF: Of the top 3000 then it is included in the index. So there are no exclusions, there is no committee. So you run into two issues there. You end up with junkie stocks but you also have the issue of front running. So because Russell is going to reconstitute their index twice a year, everyone is going to know what Russell is going to exclude and include in their index before they announce it.

[0:31:10.3] CP: Don't they break down their 2000 and do value and growth based on market cap to each bucket as the same total value so when the value bucket gen of more shares and then the growth bucket?

[0:31:19.8] BF: I didn't look into that.

[0:31:21.1] CP: Yeah, I am pretty sure. I did this years ago, I am pretty sure that is how they do it. So that actually not leaving on that middle range whereas other industries do basically. If you are either strong girl strong value or you are in the middle. Other index providers dump out the middle and just go to the extremes. I appreciate that is how they do it at Russell.

[0:31:38.7] BF: That is interesting and so anyway, IJS is in for small cap value exposure and then we also want to find market value, market wide value the way that it was going with IUSV, which is again an iShares product that is an S&P 900. So between the two, the S&P 600 value and the S&P 900 value, your total market value and then for waitings, we just did one third each in US market US small cap value and US value. So you end up with a pretty meaningful tilt towards small cap and a pretty meaningful tilt toward value, which definitely increases your expected returns.

[0:32:13.0] CP: Is this on our website yet?

[0:32:14.3] BF: No, it is not up yet but we got a paper that's just about finished that will go on talking about this. So that can be a reference and then we'll put out model portfolios too. Yeah, so anyway it ends up resembling the coach potato model portfolio from a couple of years ago when they have a couple more ETF's in there before they started using XAW. So you got your VCN for Canada. XU, you and I talked depending on what type of account you are in for US.

And then the IUS VNIGS that we just mentioned and then VIU and NVEI we ended up going with Vanguard for international developed and emerging markets but the interesting thing when you look at the historical data on our new model portfolio, going up to 10 years it has trailed by about 30 basis points, which you'd expect because we know value particular in the US has underperformed for 10 years but then going out 20 years.

You end up with 36 basis points of annualized excess performance just by adding those additional weights to the small cap in value US market. So this is amazing, right? We are not even going –

[0:33:10.8] CP: Because you use the ETF or using the –

[0:33:12.8] BF: ETF.

[0:33:13.2] CP: In the in decease.

[0:33:14.2] BF: ETF this is live evolve –

[0:33:16.2] CP: Because ETF had real net of MER returns.

[0:33:18.3] BF: Yeah, exactly. So that has been meaningful, right? 36 basis points per year on average and that is including this past decade, which has not been very kind to small cap or value stocks and I guess the big thing is for people to trust that these things are going to persist and I don't want to keep going on but there is good reason to believe that they would persist and this one little 10 year period that we are in right now is not a reason to stop including small cap in value for the portfolio.

[0:33:43.6] CP: So going forward, this would be the portfolio we talked about in terms of performance and comparison purposes.

[0:33:48.7] BF: Yep, I got one more data point that I think is fascinating to talk about. The lowest one year return is a bit lower for our small cap in value tilt to portfolio, which is what you would expect. It is a little bit more volatile with the small cap and value tilts. When you look at the three year, the lowest three year return, the proposed model portfolio with the additional small cap in value is 3% higher than the market cap way to ETF portfolio.

And that is when you start thinking about draw down and retirement and stuff and accumulation but 3% higher returns over the lowest three year period, I mean that is meaningful.

[0:34:19.9] CP: Per year.

[0:34:20.8] BF: Annualized. That is right but that's what you'd expect because you're adding in independent risk factors. Anyway, so the paper introducing these portfolios and way more data on why people should be thinking about small cap in value is going to be up on our website soon but other than that, I think that's it for today. Anything else?

[0:34:38.6] CP: No great info.

[END]