EPISODE 46

Raw Truth of Investment: Why the Best Investment Advisors Cannot Beat a Dart

[INTRODUCTION]

[0:00:05.8] 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.

[0:00:15.5] Cameron Passmore: Coming up on the one-year mark of the podcast.

[0:00:18.3] BF: That's true.

[0:00:19.6] CP: Yeah. We got some really great guests lined up that we're going to be meeting this summer. I think we've got guests all the way through Labour Day. That's really cool. Now chase some momentum and people are seeing it online, we're able to get introductions to some pretty cool people. That's fun.

[0:00:33.6] BF: It's absolutely true. I think I say this too much, and maybe I don't, I don't know. Maybe I don't say it enough. We definitely appreciate everyone that's listening and everyone that's sending us – I mean, again, I've said this before, but I'm getting at least a couple of e-mails a week from people saying, "I heard you say this. What did you mean by that?" Or, "Have you thought about talking about this in the podcast?" It's really engaging for us.

[0:00:53.9] CP: I mean, when you meet someone new, like get your investment flaws. I've been listening to the podcast, or watching the videos.

[0:00:59.3] BF: Oh, that happens all the time now. Yeah.

[0:01:01.5] CP: They know us I think and they've accepted in bottling the philosophy. This week was our episode with our format of a couple current topics, a couple interesting stories we found.

[0:01:11.9] BF: Yeah, it was a good episode and not a whole lot to say about it. We’ll obviously get into the episode in a second. Have a listen.

[0:01:16.6] CP: All right, there you go.

[EPISODE]

[0:01:23.2] BF: Welcome to episode 46 of the Rational Reminder Podcast. We're still following our old new format?

[0:01:30.4] CP: Yeah, I think it's working well. We're getting good topics, good ideas, certainly no shortage of content.

[0:01:35.5] BF: For the first current topic we had for this week, someone sent me this article from The Wall Street Journal talking about the Sohn Investment Conference. If anybody doesn't know about it, it's a fundraising conference where they bring in – it's supposed to be the best people on Wall Street. They bring in – the people that come in, the speaker, they're serious people.

[0:01:52.5] CP: They've raised some serious money too.

[0:01:53.8] BF: Oh, yeah, it's a great cause. It goes for child childhood cancer research.

[0:01:57.7] CP: They've raised 85 million dollars over the past 20 years. This is a big deal on Wall Street. It's also co-sponsored – I found a YouTube video on it, co-sponsored by CNBC. It's a big deal, big names that come out.

[0:02:09.1] BF: The hook is that you're getting access to hedge fund, or proprietary investment managers who would not normally disclose their investing ideas to the public. You're getting to hear them speak about their best investing ideas at that time.

[0:02:24.3] CP: Which for them, I'm sure is very entertaining to go and listen to this, and potentially good moneymaker. For us, it would also be very entertaining. I mean, you imagine going to see this thing, it'll be hilarious.

[0:02:33.2] BF: I mean, it would be cool.

[0:02:34.4] CP: Be very cool.

[0:02:35.3] BF: Genuinely. Even though we think that that type of investing is not the smartest thing in the world, these people are still brilliant. However, you want to slice, they're smart people. The tickets for us to go as financial professionals, 5 grand US.

Anyway, so Wall Street Journal last year, they took the stock picks of all of these people. You've got these hedge fund managers going up on stage and talking about their best stock picks, long or short.

[0:03:02.8] CP: It was what? 12, 13 people?

[0:03:04.6] BF: Yeah, something like that. Yeah. Wall Street Journal recorded all of their picks and both long and short. Then they went back to their offices, I guess and opened up a newspaper, pinned it to the wall and literally threw darts at stocks.

[0:03:19.9] CP: At the stock pages.

[0:03:21.0] BF: In the stock pages of the newspaper. For the 2019 conference, Wall Street Journal came out with an article talking about that experiment. The stock picks of the dart throwing smoked the professional stock pickers.

[0:03:36.4] CP: Well, solidly enough and I've heard this example before, going back to a little bit of science. That's what you would expect, wouldn't you? Because there's more small cap stocks in the pages of the paper, so you'd expect it to outperform anyways.

[0:03:47.9] BF: I guess so.

[0:03:49.2] CP: From a purely theoretical standpoint.

[0:03:50.8] BF: If you did maybe 10,000 of those trials, maybe. In this one, I think it's just luck.

[0:03:55.5] CP: Pure random luck.

[0:03:56.3] BF: Yeah, but it's still interesting. It was 30% outperformance by the dart throwing over that one-year period.
[0:04:01.7] CP: Did you see the guy that won?

[0:04:03.2] BF: No.

[0:04:03.5] CP: I saw an interview with him. Young guy. He's a manager. it's Andrew Wilkin of I it's called Rangeley Capital? He was on at CNBC explaining his pick and had a whole story around Wyatt La Quinta, which is the hotel chain was such a good choice and it's the – he's the guy that won the contest.

[0:04:26.4] BF: They had Jeffrey Gundlack, who is a name that I knew from DoubleLine Capital. His recommendation for last year was short Facebook and long Spider S&P, oil and gas ETF.

[0:04:38.8] CP: Didn't work out?

[0:04:39.2] BF: He got smoked up both sides. I mean, it's entertainment at the end of the day, I guess.

[0:04:44.1] CP: It's entertainment. It's a great cause. It's what these people do. You have to even credit for taking what they believe in and racing a lot of cash for something that pediatric cancers.

[0:04:53.0] BF: On the other side of the coin, it is fascinating to see who should be the best. If anyone's going to be good at doing this, it's going to be these guys. It's not going to be me.

[0:05:01.1] CP: No.

[0:05:01.5] BF: It's not going to be you.

[0:05:02.5] CP: I wouldn't be standing by of your invitation.

[0:05:04.7] BF: If anybody's going to be good at that, it's going to be these guys. In this sample anyway, they sure fell short, which is what you'd expect.

[0:05:13.5] CP: The other current story is one that we have talked about forever.

[0:05:16.0] BF: Very much related to what we just talked about.

[0:05:18.2] CP: Absolutely. I remember back when we did the radio show business at night, we should talk about the Spiva reports, that's the Standard & Poor's index versus active scorecard. Once again, it's absolutely no surprise, they measure how well did active money managers do versus the index. As you just said earlier, once again, they got smoked. I mean, the story never changes. It's same every year.

[0:05:40.9] BF: It is the same every year, but I think it's particularly interesting to look at this data in a year where the market was particularly bad.

[0:05:47.2] CP: Yeah, all you had to do is make a proper choice in the fall of last year and you would have avoided the rough last six weeks of the year.

[0:05:54.3] BF: That’s a pitch, right? I mean, it’s part of the pitch anyway. An active manager said – they're not necessarily saying, “I'm going to knock it out of the park every year,” but they're definitely saying, or at least a lot of them are definitely saying when markets are bad, we'll protect the downside. That's a huge part of the active pitch.

[0:06:08.3] CP: Yup. We've heard from a few people we met this week. The main line of the story that I read out of it, they took an overall look at all the different asset classes and 75% of Canadian funds overall underperform the representative index from all the different asset classes. The common pushback of course, is index funds also underperform the index.

[0:06:33.0] BF: Right. 100% of index funds are going to underperform.

[0:06:35.8] CP: That's right. You have no chance of beating it, which is a mathematical. You mustn't forget either, you can't get the full index return, because there's always some expense ratio in there, but you can get pretty close and replication that was so good.

[0:06:49.7] BF: That's the thing. My favorite counter-argument to what you just said, which is something that we hear relatively often. The counter to that is sure, but index funds underperform by their tiny, tiny little fee, and maybe buy some withholding tax depending on the asset class we're talking about. Active funds are massively underperforming, at least on average. It's not they're just underperform by a little bit. In a lot of cases, they're underperforming on average by even more than their fees.

[0:07:14.0] CP: Of course, you know advisors are not finding the below average funds.

[0:07:17.9] BF: Stop. Stop it.

[0:07:19.7] CP: Just a little baiting going on.

[0:07:21.0] BF: I looked at the data on that too, the Spiva report had the asset weighted performance of Canadian funds against the benchmark index. That's weighted by the magnitude of assets in each fund. The biggest fund that's –

[0:07:33.3] CP: It's where the money is.

[0:07:34.5] BF: Where the money is. Right, which is what really matters. The average asset weighted return for Canadian equity mutual funds in 2018, so just for the calendar year was negative 10.06%. Well, the Canadian index as in PTSX composite was down 8.89%.

[0:07:50.5] CP: I didn't dig in the details, but do they look at all funds, or they blinded expense ratios?

[0:07:57.2] BF: They don't actually disclose – it's not anywhere in the Spiva report, but I e-mailed the guy that prepares it a couple of years ago and he said that they mostly use A class funds.

[0:08:07.6] CP: There is advisor comp in there. They underperform by was that? 1.15% Because yeah, there's probably a point of adviser compensation and their 1% of advisor compensation. As they're weighted, they're basically doing the index.

[0:08:24.0] BF: Hey, not bad.

[0:08:24.8] CP: If not a little bit – basically in the index, because there's advisor compensation, plus a manager compensation. They pretty much are doing the market, which is pretty much what you'd expect in aggregate.

[0:08:34.0] BF: Maybe they did add some value that year, just not so much after costs.

[0:08:37.2] CP: Right. You can make the case. It's not really fair to have the index funds not have advisor compensation in it.

[0:08:43.8] BF: Okay, but let's keep going. Small cap Canadian equity funds were down 16 asset weighted, down 16.39%, while the TSX completion index was down 12.85%. Story falls apart in that asset class.

[0:08:57.6] CP: I thought the small caps is where managers can add value, because they can be more nimble. There's greater disparity.

[0:09:04.1] BF: The small cap market is supposed to be as the story goes, less efficiently, because there are less people looking at it, which is supposed to be a reason that active managers can add value there. We sure didn't see that last year.

[0:09:13.8] CP: Didn't they get smoked on US equity too?

BF: Oh, yeah. US equity in Canadian dollars returns for the S&P 500 were 1.83, or sorry, asset weighted US equity funds in Canada were +1.83% last year, while the S&P 500 was +4.23.

[0:09:29.8] CP: Don't forget. I mean, once again, young you based on what the trolls are saying, you're looking at evidence and science and should just be looking at sporadic one-off evidence that people earn returns.

[0:09:42.1] BF: Yeah, someone wrote –

[0:09:43.3] CP: You've had crazy stuff troll to you this week.

[0:09:46.0] BF: Someone wrote a response to my Globe and Mail article, which I don't even want to talk about most of it. It was something. One of the points that he made was that he was actually – he tweeted at me saying, “I'm going to respond to your Globe and Mail article.” I said, “Okay, but that was just scratching the surface.” Here’s a link to my YouTube video, respond to that if you want to respond to anything, because I went into way more detail there. He did. He says in the video when I start talking about factors, which by the way are the foundation of our understanding of financial markets, when I started talking about –

[0:10:14.0] CP: The understanding, not just our. This is –

[0:10:15.7] BF: Yeah, yeah, yeah. This is it.

[0:10:17.6] CP: This is it.

[0:10:19.0] BF: Not us.

[0:10:20.2] CP: Not us.

[0:10:21.9] BF: Yeah. His comment was that when I started talking about factors, it made him think of his daughter who's in elementary school. The factors were her getting good grades, but successful dividend investors were her actually understanding of the material that she was learning. Yes, I also made that face.

[0:10:40.2] CP: Okay. I don't understand, but it's –

[0:10:41.7] BF: Well, it's basically just saying that we're being too academic. Academia is not reality.

[0:10:46.6] CP: Those that can't teach and those that can do, I guess that's a factor.

[0:10:49.6] BF: It’s a similar story, I guess.

[0:10:51.5] CP: The argument. Anyways, these reports come out every year. They have forever, it's never the different story ever. I don’t think I have ever seen a story on the Spiva report be different.

[0:10:59.9] BF: The other piece of data that's in there though that's pretty interesting is the survivorship. They've reported on 10-year survivorship for Canadian funds. If you look across all the different asset categories and it's roughly 50%.

[0:11:12.4] CP: You would think that the survivorship would be going up, because so many funds have been killed off.

[0:11:19.0] BF: They’re creating new funds though.

[0:11:20.6] CP: Are they? I guess they are. I would think with the marching of assets away from active towards passive across the world, maybe less so in Canada, you would think that that survivorship number would be going up, but it never seems to go up.

[0:11:33.0] BF: There are a lot of funds. I mean, you think about the – it's not that people are migrating toward indexing. I think the general investing philosophies are shifting, which means fund managers are making factor products and they're making quantitative products, as opposed to traditionally actively managed products.

[0:11:49.2] CP: The mix of products is shifting perhaps.

[0:11:52.3] BF: Right. You're still getting new active products all the time. Then the other piece of that is if we take – if we say, okay this 50% of funds survived over the last 10 years and those funds may have been successful, because the manager was skilled, but it may have been because he was lucky, or she was lucky. We know from the research that they're much more likely to have been lucky than skilled.

You wouldn't expect those 50% that survived over the last 10 years to survive the next 10 years. You'd actually expect a lot of them, maybe 50% of them to also collapse, just because they were lucky and that's why they got successful and now, maybe they'll get unlucky. Anyway, so Spiva report comes out twice a year like you said. It's always interesting. Like I said, when we started talking about this segment, it's particularly interesting in years where the market is down, because that's where active managers are supposed to shine. As we can see from the data in this year's report, you were no better off in active funds than you were just being in the index.

That argument falls apart. Standard and Poor's actually did an article on seeking alpha when they released their report and they talked about the points that we made and a couple others too. They talked about this data busts the myth on active beating, passive in down markets. It bust the myth on active managers adding value in small caps, because Canadian small cap funds did terribly.

[0:13:08.7] CP: Yeah, we have a guest coming up in a few weeks, we hope with someone from Standard & Poor's. That'll be a great interview.

[0:13:14.3] BF: Yeah, that will be.

[0:13:16.0] CP: Low-vol stocks. You're getting questions about low-vol stocks. This is our portfolio topic this week.

[0:13:21.6] BF: I've been getting questions about low-volatility for a while.

[0:13:24.4] CP: What a great name. Who doesn't want low-volatility? I looked up what is a low-vol stock. Get this, this was on Google. I just did it. Volatility is a variation in price and low, means the variation is lower.

[0:13:38.4] BF: It adds up.

[0:13:40.3] CP: That's appealing.

[0:13:40.9] BF: That approximately makes sense.

[0:13:43.3] CP: I'm joking. That's exactly what it is, obviously.

[0:13:45.6] BF: Yeah, so on the YouTube channel, a lot of people ask just in the comments, like can you do a video on low-volatility stocks? Or to leave and ask more involved questions, like okay, but you just said that market beta explains two-thirds of returns. How can that be true if lower beta stocks tend to have better returns? That's a valid question. I just wrote a YouTube video on that topic, so I thought it'd be good to talk about, just because we have all the data from that.

[0:14:11.8] CP: It's being marketed, so there's a lot of fun brand names coming out now with low-vol portfolios.

[0:14:17.1] BF: I think the biggest selling point for low-volatility stocks and low, you explained it, but the low-volatility means market beta, that's the risk of the market. If an index fund, for example, like a US total market index fund would have a market beta of 1, well it is the market, so if the market goes up 10%, that portfolio goes up 10%. A low beta portfolio is a portfolio with less sensitivity to the market. If the market goes up 10%, portfolio with a beta of 0.5 might go up, well it would go up 5%. You'd expect it to go up 5%. That's low beta. Lower volatility than the market. Over the last 50 years, low beta stocks have been anomalous. They've had higher returns than you would expect based on the amount of their market sensitivity.

[0:15:03.6] CP: Market inefficiency.

[0:15:06.0] BF: It appears to be the market is not pricing in some type of risk, or it's not accurately pricing those types of assets, because you would expect a riskier asset to have a higher return. That's how the market is supposed to price assets in an efficient market. Thinking about through just through market beta, it's very clearly an anomaly. Low beta stocks, they definitely have higher returns and they should based on their market betas.

[0:15:28.4] CP: Listeners of the podcast know that we talk about the factors. I'm sure many people are thinking, “Okay, factors must explain part of this. What's going on here?” Hopefully, that's a normal reaction, now that people are getting the philosophy. That's not a free lunch.

[0:15:44.3] BF: You can backpedal, I think. You can backpedal and think about small cap and value stocks, which we've talked about a fair amount in the podcast. You go back pre-1992, or maybe even a little bit earlier than that, but pre fom a French three-factor model. If you looked at small cap stocks, for example through the capital asset pricing model, so just through market beta, small cap stocks have higher average returns than would be expected by their market beta.

Market goes up X amount, small cap stocks co-vary with the market by a certain amount, but they have higher returns than you would expect based on that co-variation with the market. It appears through the single-factor model, through the capital asset pricing model, it appears that you're getting higher returns without any additional risk.

[0:16:30.4] CP: There has to be a but coming.

[0:16:31.9] BF: Well, that seems like an anomaly, right? Then the same thing was found for value stocks. At the time, this was disproving efficient markets. It was saying okay, capital asset pricing model is the model we have to relate risk and expected returns. It's not able to accurately price these types of assets. It’s not able to predict the expected returns of these assets.

Anyway, so over time, papers come out about small cap and value and then Fama and French wrapped it up in 1992, saying the reason that their average returns are higher is not because they're magical, it's because small cap is an independent risk. Value is an independent risk. Now if you run the three-factor model on small cap and value stocks, there's no longer a higher average return than you'd expect based on the risk taken. It's just that they're taking more risk. They're taking market risk, small size risk and value risk, where they've got exposure to those factors, is another way to say it.

[0:17:31.4] CP: Okay, so let's bring this into low-vol stocks.

[0:17:33.2] BF: This is where it gets interesting is that you take the three-factor model and look at low-volatility stocks through that lens. Even based on their market beta’s size, exposure and value exposure, they still have higher average returns than you'd expect.

[0:17:47.8] CP: This is where your hero stepped in and gives you an answer.

[0:17:51.0] BF: Who's the hero? Fama and French?

[0:17:52.3] CP: No. Dr. Robert Novy-Marx.

[0:17:54.3] BF: Right. Well, Fama and French and Novy-Marx all solved this. In 2013 was when Fama and French came up with their second big factor model paper, where they said, “Okay, in 1992, market size and value.” Those are the factors that we understood to explain differences in returns. Then in the 2013 model added two new factors. They said profitability and investment are quantitative characteristics of stocks that we can use it to explain differences in returns. When you apply that factor model, you can explain low-volatility.

Basically, what it ends up being is the low-volatility stocks are stocked with low betas, but they're also value stocks and they’re stocks with robust profitability. Through the five-factor model, they’re stocks that also invest conservatively. There we go. Market’s efficient again. It's explained through exposure to known factors. Low-volatility is no longer an anomaly.

[0:18:54.0] CP: Is low-volatility basically just a rebranding of the factors?

[0:18:56.6] BF: This is the problem, sort of, sometimes, this is the challenge. If you look at low-volatility stocks, if you look at low-volatility stocks, most of the time they're going to be value stocks and they're going to be stocks with robust profitability, most of the time. I have the data point.

[0:19:11.4] CP: It's also what you're excluding too, isn't it? Because we talked about that a few weeks ago. Small cap works because of what you're leaving out of the portfolio.

[0:19:18.2] BF: Yeah. Novy-Marx in 2016 did a paper on this as well. He showed with his research that the tilt toward low-volatility stocks is beneficial, mostly because it excludes small cap growth stocks with weak profitability, which we know to be not good stocks in general. He's saying that yeah, low-vol has looked good in the past, but it's looked good more so because you're excluding small cap growth with weak profitability, then because you're focusing on the low-volatility stocks.

His points in his paper, Novy-Marx's point is that because of the benefits of low-volatility are mostly coming from excluding small cap growth with weak profitability, it would be far more efficient to just take a market index and exclude those stocks, as opposed to building a relatively concentrated portfolio with relatively high turnover around this small subset of low-volatility stocks. Does that make sense? Do you need to back it up for our listeners? Because I'm –

[0:20:15.0] CP: I think we're good. It's all about the engineering the portfolios based on these known factors of what should be in and what should not be in.

[0:20:22.0] BF: I looked at USMV, which is the largest I believe low-volatility ETF. It's a US-listed ETF.

[0:20:30.1] CP: 25 billion dollar portfolio. It's huge.

[0:20:32.2] BF: It's a big fund. It's got 213 holdings, compared to if you look at ITOT, which is total market US index ETF, it's got 3,552 holdings. We start thinking about that, you've got to – get access to low-vol, you're taking this massively concentrated portfolio, which is probably going to have –

[0:20:50.8] CP: Well, still 213 holdings. I mean, we've seen people come in lately with high conviction portfolios at 15 stocks.

[0:20:57.0] BF: Sure, it's more diversified than that. The more holdings that you have, the more diversified that you are, the tighter your dispersion of returns comes. With the 213 holdings, you might be getting some access to low-volatility, which is really just value and profitability. That's where the benefit's coming from anyway. You're also getting this relatively concentrated portfolio. The other metric that I looked at for US MV was turnover.

[0:21:19.1] CP: This was a big number.

[0:21:20.4] BF: Yeah. You get the same thing with a small cap value fund, like IJS, 25% turnover, compared to 10% for ITOT, which is also high, I thought. Anyway. What you'd expect though and what Novy-Marx is saying in his paper is if you target low-volatility specifically, you're going to get a concentrated portfolio with relatively high turnover. It's an inefficient portfolio. Because the benefits is coming from excluding the small cap growth with weak profitability, you're better off just starting with the market and excluding those types of stocks, as opposed to targeting the low-volatility. It gets even more interesting, in my opinion anyway. There's a two –

[0:22:01.8] CP: People asked for this, remember that. We had requests for this topic.

[0:22:04.7] BF: On the YouTube channel to be fair, maybe the podcast listeners are going to hate it. There's a 2012 paper by someone named Pim van Vliet. They found that while it's true that on average, low-volatility strategies do have value exposure, which is where a lot of the benefit comes from, historically low-volatility has been in a value regime only 62% of the time. On average of a long-term, sure, you're getting value exposure. Only in 62% of historical period.

[0:22:33.6] CP: There's no time for system exposure to the value, which is what you'd want if you're following the Fama French factors.

[0:22:39.4] BF: Right. If you're following low-volatility, you're not getting consistent exposure to the factors. If you believe that the factors are what explain differences in returns –

[0:22:47.6] CP: We're just believing evidence.

[0:22:49.0] BF: Believing evidence and believing in market efficiency, then you want to consistent exposure of the factors, not inconsistent.

[0:22:54.2] CP: That's really interesting.

[0:22:55.7] BF: Then it gets even more interesting, because this paper, they also looked at – they looked at the performance of low-volatility when it's in a value regime, versus when it's in a growth regime. They found that on average, low-volatility stocks have outperformed the market by 2% when they're in a value regime and they've underperformed by 1.4% when they're in a growth regime, which is what you'd expect, just based on the factor exposures.

Anyway, so the point is it's – it was an anomaly up until 2013 when the five-factor model came out. Fama and French, I think they did a paper specifically addressing, looking at anomalies with the five-factor model and they specifically address low-volatility and showed that the addition of the profitability and investment factors explains it.

[0:23:39.3] CP: I think the big take home is don't be swayed by marketing and branding and labeling of these products. The factors, it's science. Understand the science and you can just forget about all this stuff.

[0:23:50.7] BF: I looked at ITOT too, and it's like yeah, you want to exclude small cap growth with weak profitability, but small cap growth is 2% of ITOT. Are you better off with total market with that little bit of small cap growth, which you don't really want, but it's not that much a portfolio.

[0:24:04.9] CP: I swing it anyways.

[0:24:05.6] BF: Or are you better off with this well, relatively highly concentrated portfolio with higher turnover and higher fees and all that stuff?

[0:24:11.8] CP: On to the planning subject?

[0:24:13.3] BF: Yeah, I guess so. I'd finish off by saying that I would not add low-volatility to a portfolio, just because you're getting inconsistent factor exposure.

[0:24:20.8] CP: Get the factors you want and I want water loss for water.

[0:24:23.6] BF: Even if we look at IGS, which is small cap value, it's at least got consistent exposure to the size premium, the value premium and the profitability premium. Consistent, like since inception. Whereas, with low-volatility you're getting this time varying factor exposure, so you don't really know what you're getting, I guess is the challenge. Onto the next.

[0:24:42.1] CP: Onto the planning? I think this is a good item. I did some extra research on it. Financial FP Canada, which is the formerly financial planning standards council, came out with their assumptions that planners should use in building their financial plans.

[0:24:59.0] BF: Guidelines they call them.

[0:24:59.7] CP: Guidelines, they're called, and help you with what inflation rate you should use and the rates of return expectations for different asset classes. It's interesting how these are in-line with what – I mean, my first observation is they're in-line with what we use in our planning?

[0:25:15.2] BF: Now to be fair, we participated in building the BOW capital –

[0:25:19.4] CP: Yeah, they gave us a shout-out in there too. Thanks and –

[0:25:21.8] BF: Oh, they did a survey? Then we responded to the survey with our expected return assumptions. They did 25% weight toward those survey results in developing their expected return assumptions.

[0:25:31.9] CP: Yeah. I thought it was cool how they weighted the given – an equal weighted average of estimates from CPP and the Quebec pension plan actual report and the survey of other professionals like you mentioned, and then some historical data. It seems like a reasonable way of coming up with numbers. They come out pretty close to ours, which is maybe weighted a bit differently. They're all in that zone of for equities between low 6% and low 7% per year.

[0:25:59.9] BF: They're really important. Now, I got to also say that I don't agree with you. It's interesting the way that they develop their assumptions. I don't think it's – well, I don't want to say it's not smart. It's not how I would have – well, it's not how we do it.

[0:26:11.7] CP: Yeah, but you get to a reasonable, because the point being I think is that so many people use much higher numbers. For example, I looked up one with Dave Ramsey, our good friend Dave Ramsey uses the Massive Podcast review.

[0:26:22.8] BF: 12% or something.

[0:26:24.0] CP: 12%. I went to his website and said –

[0:26:26.5] BF: Is that it? 12%.

[0:26:27.4] CP: Here's a quote, “It's not difficult to find several mutual funds at average or exceed 12% long-term growth, even in today's market.” Then he goes down below and says, the market has earned, I think he says 11.97 average return, has been 11.97% for the past – since 1923. I'm like, “That sounds high.” I go to our data set that we have here. I look it up and it's actually closer to 10. I'm like, “Where is that 2% spread?” His number is not compound. It's the average annual return, not the compound return. I think you actually eat the compound return, right? Not the average return?

[0:27:08.2] BF: Yeah. I would say that is true.

[0:27:09.7] CP: That's a 200 basis point spread right there. Obvious next question, where are fees in this?

[0:27:16.2] BF: You know what? He's not wrong. I could go find you a whole bunch of mutual funds that have returned 12% over the last 10 years. I couldn't find the ones that are going to return 12%, but I could find the ones that have.

[0:27:27.3] CP: That have, for sure. I mean, Jack Boldwood came out a few years ago and said, it's safer to assume something in the 6% range.

[0:27:34.9] BF: Yeah. I think that, I don't know where people get these numbers, but I'll often talk to people who have maybe used an online calculator that they found that had a default rate of return in there. It'll often be 7% or 8%, which is yeah, I would say that's probably high. I think what I was going to say about the way that FP Canada arrived at these figures, they weighted other people's expectations, which I thought was just – it's a little strange. I mean, sure. I'm happy with the way that we arrived at our expectations. I'm sure that CPP also does a good job. I'm sure that QPP also does a good job.

There is an evidence-based way to develop expected return assumptions. The evidence shows that the most reliable way to estimate future returns is based on current price earnings. That is the single most accurate way. Buckingham, Larry Swedroe’s firm, that's all they use. They use the current implied rate of return based on the price earnings at that time. Now we don't do it that way. Well, we do do it that way, but we weighted. We do 50% current implied rate of return based on price earnings. The reason that's important is because when prices are high, your expected future return is lower, which is what the data show. The data show that if prices are well, what I said.

[0:28:42.8] CP: We've talked about that many times.

[0:28:43.8] BF: Right. What we do though, which is different from what Larry Swedroe from Buckingham does, they just use that implied rate of return from the price earnings, I think.

[0:28:53.0] CP: Are they putting in the premiums at all in their return expectations?

[0:28:55.7] BF: They do. Yeah, Buckingham does one-third of the past premiums.

[0:28:58.5] CP: We don't include any premiums and ours were broad market on the assumptions.

[0:29:02.2] BF: Yeah, which is a conservative – well, should be a conservative assumption. Anyway, we do 50% the current implied rate of return and 50% 50-year historical average. The reason that we do that, even though that's not necessarily the evidence-based way to do expected returns, the reason that we do that is it decreases the volatility of the assumptions. If you're constantly changing based on price earnings, you could have a much higher expected return at one time and much lower at another time, which means if you're doing financial planning based on those numbers, you're like, how much you need to save, or how much you can spend. That could be relatively volatile.

[0:29:34.6] CP: We follow the guidelines for inflation. The plans we've been doing lately are now using the 2.1% inflation rate. We made that change right away.

[0:29:42.2] BF: Which actually makes our planning assumptions that we've used, that we are currently using have a 1.7% implied rate of inflation built into them. Using the 2.1 makes our planning a little bit more conservative. Yeah, so I think you mentioned the numbers, but the – yeah, there we go. With FP Canada's planning assumptions, with a global portfolio excluding Canada, you're expecting a 6.48% return. That's US, international and emerging markets.

[0:30:09.2] CP: Just equity. No bonds.

[0:30:10.6] BF: Just equity. 6.48%. For Canada, FP Canada's saying you should expect 6.1%. Depending on your weight of Canada route to other stuff, you're whatever, 6.3 or something like that, for equities. Fixed income, FP Canada is using 3.9%. I also looked at our expected returns. For Global X Canada, we're 6.61% is what we're using. That's a little bit higher than what FP Canada is using. For Canada, we're 6.5, which is again a little bit higher.

[0:30:41.8] CP: All of our planning is to a net of fees.

[0:30:43.7] BF: Yeah. FP Canada talks about that in their report too that you've got to take fees into account appropriately.

[0:30:48.6] CP: So many times, people aren't aware of the fees. The fees don't come up in the planning. They use 8% rate of return. With no mention, the fee is very simplistic. It makes a huge difference over a long period of time.

[0:30:59.2] BF: You really talk about 10%.

[0:31:01.2] CP: Yeah. Let alone if you start doing some randomization of the return, so the Monte Carlo analysis, which we always do.

[0:31:06.5] BF: Yeah, we do Monte Carlo, FP Canada the way they approach that was actually interesting. They grossed down their expected return assumptions to account for volatility. Instead of saying, "Here's the expected return and the standard deviation, go do a Monte Carlo." They reduced the return to account for.

[0:31:22.6] CP: I think you don't have the conversation with a client about how the future values will deviate potentially.

[0:31:27.7] BF: I agree. For someone who's doing this by themselves at home, then they're probably not going to have quick –

[0:31:33.6] CP: Let's say I want to make sure I have – if you're starting with a million and want a million when I pass away. I just want to live off the income. It's not a reasonable framework to build your future around, because you don't know how the returns are going to play out.

[0:31:46.0] BF: Unless you're an income investor, I guess, and you only spend the income. That was a joke. No one's laughing.

[0:31:50.9] CP: All your friends online got it. Okay, you want to go in the worst advice of the week?

[0:31:55.2] BF: Yeah, I think that’s good for –

[0:31:56.2] CP: We had a bunch to choose from, but you chose this one.

[0:31:58.1] BF: I thought this one was pretty good. It was a little bit technical, I guess. It wasn't screamingly bad advice.

[0:32:03.8] CP: I’d take the title of the article though. ETF industry bedding the traditional value strategies need tweaking. What a loaded article title. It was in Barron's, right?

[0:32:14.4] BF: Yeah. It's called three-value ETFs for a new value stock. They're basically saying that the old way of defining value is no longer any good. Using book to market, which is what the original value research used, they're saying, “Yeah, that's no good anymore, because the world's changed. Things are different now. Companies are valued different ways. Companies ask. Balance sheets are different.”

They're suggesting there are ETFs out there that are using different kinds of value metrics in order to access the value premium. One of the problems with that is that over a given period of time, like book to market has had a bad decade. You can go and find value metrics that look better over the last decade. That's going to be true at any time period.

[0:32:54.0] CP: That doesn't mean that value has changed all of a sudden.

[0:32:56.6] BF: It doesn't mean the value has changed and it doesn't mean that those other alternative specifications give you better access to the value premium.

[0:33:02.6] CP: I wonder how much this is just – the media. I mean, that particular publication having to fill an article.

[0:33:08.4] BF: I mean, I think this is genuinely, like you look at Rafi, which they mentioned in the article the fundamental indexing company. They genuinely believe this. This isn't just Barron's saying we need to fill the page. Rafi is their whole pitch, is traditional ways of viewing the stock market are wrong. They use their fundamental indexing strategy, which use – that's what they do. Rafi uses alternative specifications for stuff like, value to find stocks that have been mispriced. Rafi's whole thing is markets are inefficient, which is what this article is talking about. It's like, okay, maybe markets aren't efficient anymore. Now we've got to use these different value metrics.

[0:33:42.8] CP: It’s a whole new world.

[0:33:44.4] BF: I think that one of the main – ties into what we're talking about with low-volatility. If you look at other specifications, like I don't know, price to cash flow, as opposed to price to book, those alternative specifications will often get you exposure to value, because it's still a value metric and something else.

I should’ve researched this for episode here, but I think it's price to cash flow, it gives you value and profitability. If you're building a value product with price to cash flow, you're getting value and profitability. It looks better, because you're adding profitability. It looks better in the historical data. Now you've muddied up, like what are you actually investing in? Are you getting value? Are you getting profitability? Are you going to consistently get profitability using that metric?

[0:34:28.9] CP: If you already have a strategy, why would you want to change it if you've got a good foundation and science strategy? It just seems the whole thing is just driven to get people to make it change; something's better, something – bet on this. It's not healthy to long-term investment success.

[0:34:43.5] BF: I think the way that you can always – well, that you can always. No, the way that academics will verify something like this is that if you take price to cash flow and look at two different portfolios using factors to explain the differences in returns. If you control for the no one factors, like size, book to market value, profitability, investment, all the stuff that we know about, if you control for those factors, does price to cash flow add any additional information? In that case, the answer is no. That can always be at least one of the tests for does this new thing that people are saying is going to be good, does it still add value once we control for the no one factors?

Now it does get dicey. It gets tricky, because why is the Fama French five-factor model the one that we should believe is the truth? No model is the truth. They're models. That's the point. I guess, it becomes a matter of picking a model that you believe in and how do you do that? I guess, robustness and stuff like that. I was talking to some about this a while ago and they were saying, like using low-volatility is the example. If low-volatility gives you varying Fama French factor exposure, that means the Fama French factor exposure is also giving you varying low-volatility exposure. What if you wanted to target low-volatility? You could say the Fama French –

[0:35:55.0] CP: That's true. That's true.

[0:35:56.5] BF: You could say Fama French is a bad way to target low-volatility, as opposed to low-volatility is a bad way to target [inaudible 0:36:01.2]. It all comes back to what is your fundamental belief. If you believe that market's price assets efficiently, then Fama French –

[0:36:08.3] CP: Fama French site. Interesting. I haven't thought of it that way. Is that good?

[0:36:12.4] BF: Yeah. I think that's it for today.

[0:36:13.5] CP: Yeah, next week we have a great interview on cars in the car market.

[0:36:17.7] BF: Yeah, that's a really good episode.

[0:36:19.4] CP: Yeah, it was great. Anyways, have a good week.

[END]

