EPISODE 66:

Asset Allocation Funds, Private Equity IPOs, and The Efficient Market Hypothesis

[INTRODUCTION]

[00:00:05] 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.

We covered some interesting topics today. I really enjoy talking about one of them, and it's something that I'm working on or thinking about, but it's really hard doing a video on, but it's just in social sciences and in economics, this idea of empirical and theoretical work and how those two things coexist together.

[00:00:34] Cameron Passmore: And how they clash with the reality of this industry is really interesting and how it causes behavior by participants, which is completely at odds with the theoretical underpinnings.

[00:00:46] BF: It's really just having – I think in a lot of cases, it comes down to a poor understanding of what does the theory actually say? What does the empirical data actually say and what does the empirical data mean in the context of the theory? Anyway, this is a big topic. It's something I've been thinking a lot about.

[00:01:02] CP: But it was interesting. You did a good job on it. So people will take away something from that for sure. A couple of other topics; underperformance versus mutual funds. How someone does compare to the funds they're in. A lot of talk about private equity and venture capital lately with WeWork in the news and other companies.

[00:01:19] BF: Yeah, it's a good discussion, I think.

[00:01:22] CP: There you go. [inaudible 00:01:22] good discussion. Anyways, have a listen.

[INTERVIEW]

© 2019 Rational Reminder Podcast

[00:01:30] BF: Welcome to episode 66 of the Rational Reminder Podcast.

[00:01:33] CP: So for the news item of the week, you'd pull of this article from Morning Star called Mind The Gap 2019, which looks at the gap between investor performance and fund performance.

[00:01:44] BF: Yeah.

[00:01:44] CP: So I guess we're looking at the time when you're buy in and out of those funds and how that impacts your performance.

[00:01:50] BF: Yeah, I think they're sort of trying to develop a proxy for how do investors do relative to the funds that they're in, because the fund might have 10% per year annualized returns. But if the investors in the fund are doing silly market timing and making bad decisions, or otherwise maybe it's naïve market timing without meaning to get in and out of the wrong times. I guess nobody –

[00:02:12] CP: So if you bought high and sold low, that means you did not do as well as the fund did. I mean, to take the extreme example of what they're looking to identify.

[00:02:19] BF: Yeah, that's exactly right. Now the challenge with these studies is always we don't really know why investors were timing their decisions the way that they did.

[00:02:28] CP: Correct.

[00:02:28] BF: But it is still interesting.

[00:02:29] CP: There's still some interesting data. So they said over all, the average investor lost 45 basis points, so 4.5%. They're underperformed the fund over the 5, 10 periods ending December 2018. So 10 years ending 18, 17, 16, 15, 14. Then they took an average of that gap for those periods.

[00:02:52] BF: Yeah.

[00:02:53] CF: The interesting thing that I found, I don't know if you agree or not, but the asset allocations funds actually produced a positive gap of 22 basis points of annualized returns. They broke it down in asset allocation funds, equity funds, fixed income re-bond funds and then alternative funds. The asset allocation funds, the diversified portfolio stocks and bonds actually produced a positive gap.

[00:03:16] BF: Yeah, and they've got a bit of a suggestion as to why that might be. I think there are a couple of pieces of plan. One if volatility. So because an asset allocation fund has multiple asset classes within one holding, you're not going to have the same level of volatility, and volatility is going to exacerbate the negative impact of bad market timing decisions.

[00:03:36] CP: It may also have a try to the different type of investor too. So if you're in an equity fund, you might have been searching for the hot equity fund or someone, the profile of a typical asset allocation fund may be calmer by nature not as return oriented.

[00:03:51] BF: Yeah, I think the other they say in the Morning Star article is that a lot of those target date asset allocation funds are held in 401(k) plans where people can't really take the money out. I guess they could still making bad timing decisions by changing the investment. It's like an RSP in Canada. But the other piece of that is that for retirement accounts, people are often going to be systematically shoveling money in.

[00:04:12] CP: Yeah, and a lot of those targeted funds. Not a lot of them. They all just rebalance automatically. So they take the decisions out of your hands. So they're automatically buying low, selling high the different asset classes.

[00:04:23] BF: Yeah. Again, I said that we don't know for sure why people have worst returns, like why they make bad timing decisions. Is it because they're nervous or is it because they just had to pull the money out for some other reason. But the trend where the more volatile asset classes, like they looked at alternatives in here too. As you get into the move volatile asset classes, the gap starts to get larger. So with alternatives they found that as an asset class, the funds produced negative 61 basis point annualized return. But the gap dropped the loss –

[00:04:57] CP: Yeah, so the gap widened. So the loss became even worse. So the more volatile, the more specialized the worse the larger your gap was.

[00:05:05] BF: So there's a 144 point gap that alternative investors, or investors in alternative product had. Then for all of the asset classes, for each category they looked at, they also broke it down into volatility quintiles. The most volatile quintiles, we see the same trend where the gap is larger for the more volatile funds within each type of fund class.

[00:05:28] CP: Yeah. Then they even broke it down by fee levels. So in every category, except the lowest quintile of asset allocation has a negative gap. So the cheap asset allocation funds are the only ones that had a positive gap. So you actually did better than the fund. So what's your take away from that? I mean, some of the things I noticed, boring funds work well for people. They seem to not, in my opinion, inspire fear or greed, better behavior. Behavior really matters a lot. Timing is not adding a ton of value. Obviously, just state your strategy through thick and thin. As we say all the time, fees matter a lot.

[00:06:03] BF: Yeah, fees matter. Behavior matters. This is one of the things that we're going to talk about later in the episode, is how to think about evidence. In that discussion, something that I was reading said that for any correlation, there's always going to be at least two theories describing why the correlation is happening, and it's the same kind of thing with this.

I know I've already mentioned this on this topic, but we see that negative behavior gap or the gap, whatever is causing it. We don't really know why it is, but it is reasonable to think that people who are in more volatile stuff, especially if they're not professional investors, or even if they are actually, that they might be more inclined to get in and out of the wrong times.

[00:06:39] CP: Yes, possible, and it's savvy or smarter people are going towards lower fee type things. You have a selection bias going in right away.

[00:06:46] BF: Yeah.

[00:06:47] CP: Current topic number two.

[00:06:48] BF: Kind of feeds in well. We're talking about more volatile asset classes. So the other thing we wanted to talk about was private equity, venture capital, IPOs, all the media that's been covering IPOs recently has been definitely interesting to watch.

© 2019 Rational Reminder Podcast

[00:07:00] CP: Especially the WeWork just pulled their IPO this morning.

[00:07:03] BF: Yeah.

[00:07:04] CP: We're taking this on Monday, the 30th.

[00:07:06] BF: We had Peloton recently, Slack, Uber, Lyft. Been a lot of big highly anticipated IPOs this year. But the interesting thing, and not all of them were getting slammed. I was about say that a lot of them were getting slammed. Not all of them are, like Beyond Meat has done very well.

[00:07:21] CP: Unbelievable.

[00:07:22] BF: So can't draw conclusions with IPOs in general being bad, although we are going to draw that conclusion in a minute based on some data.

[00:07:29] CP: But this WeWork one is wild, isn't it? The valuation crumble.

[00:07:32] BF: Yeah. So Wall Street Journal had a really good chart showing the haircuts that companies have taken for going public based on their last round of private funding. So what was their last private valuation pre-IPO, and the how much of a haircut did they take post-IPO relative to that valuation.

[00:07:52] CP: From that last valuation. You're not talking about from what price they went public at.

[00:07:56] BF: Correct. So that last round of private investors. How much of a haircut did they take on their investment post-IPO. So they had a whole list, but the ones I picked off were Cloudera. I don't actually know what Cloudera is, but they took a $2.19 billion haircut from their last private valuation before IPO.

© 2019 Rational Reminder Podcast

Blue Apron, 104 million. Pinterest, 2.24 billion. WeWork, if they had gone public at 15 billion, would have been a $32 billion haircut relative to the valuation at their last private investment. That's insane.

[00:08:29] CP: It's unbelievable.

[00:08:30] BF: But I think it speaks to just the whole concept of private investing and investing in a market that is less liquid and there's maybe a little bit more information asymmetry. Public financial markets, everyone has the same information and it's easy to access information. It's easy to trade. Transaction costs are extremely low. But as soon as you get in the less liquid markets with less information, people just pick a value.

WeWork is a perfect example. SoftBank just decided what they thought it was worth and invested at that level. Then when they took it to market everyone's like, "Whoa! Hold on."

[00:09:01] CP: Given that asymmetrical information is somewhat interesting. I listened to Patrick O'Shaughnessy's podcast week with Bill Gurley. Did you listen to that one yet?

[00:09:09] BF: No.

[00:09:09] CP: Where they talked about the direct to market versus IPO of shares when you go public, and Bill Gurley talks about how much money is wasted going to the IPO process. But he says, "In your lifetime, you're likely to only go public as a person once, whereas the investment banks have lots of experience." So he think that's one of the reasons why many companies do go the IPO route.

But he says the changing technology and efficiencies, direct to market can save a lot and get quicker, broader exposure, more fair to more people. Therefore, get better pricing.

[00:09:42] BF: Slack did it.

[00:09:43] CP: Yeah, for sure. Spotify too. So the rules are such that you can do that now. But I think most companies are still not going direct to market.

© 2019 Rational Reminder Podcast

[00:09:53] BF: Oh, no. I mean, those were anomalies. Slack going was a big deal. Now they got smoked after they listed their shares. Their shares have not done well on the public market, but they saved a lot on investment banking fees, which is good for them.

Just on the topic of SoftBank and WeWork, I think it's fascinating to think about just the skewness in probably – Well, in public stocks too, but maybe it's more extreme in private equity and venture capital. But SoftBank won a massive bet with Alibaba. They were in early. That basically made the fund, but their other investments have not been as good.

[00:10:30] CP: But there's just so much money around. Georgia & Partners in Toronto are now seeing a new billion dollar fund in Canada.

[00:10:36] BF: Largest fund Canada, I think?

[00:10:37] CP: It's the largest private equity fund ever in Canada. Blackstone even no-tier $26 billion fund. I listened to Ted Seides, who was on our podcast a few weeks ago. He interviewed this week on cap allocators someone by the name of Joe Lonsdale, who's a very successful VC in the San Francisco, and he talks about how much money is pouring into that area demanding less return. Therefore, paying higher prices.

[00:11:03] BF: Paying higher prices, and that's the tricky part, is that why are you paying that high price and who decided what that price should be?

[00:11:09] CP: Just when there's so much money, I guess you have lower return demands. Therefore you're paying more for the same asset.

[00:11:15] BF: But with a massive skew. That's the thing. It's not as easy to diversify in VC as it is in public equities. We know there's a big skew in public markets. We know that from 1990 to 2018, 1.3% of global stocks were responsible for all of the risk adjusted returns of the market as a whole. We know that, but we can use index funds to take advantage of that fact.

[00:11:36] CP: And that's in public markets. That number came out fast and regular listeners know this stat. But it's an unbelievably small amount of shares that deliver all the access return.

[00:11:46] BF: Yeah. So the study that came out this year, I think, that looked at 1990 to 2018 global stock returns, and it found that 1.3% of the stocks that existed in the market over that time period drove all of the returns in excessive T-bills. So if you missed those 1.3% of stocks, you ended up with negative risk adjusted returns. Pretty crazy stuff.

Now, with VC, that skew is arguably more extreme as I've mentioned a couple of times. But I found one study that looked at VC returns from 2004 to 2013. So I was looking at 21,640 financing over that period and they found that 65% of those deals had between a 0 and 1X return. 25% had a 1 to 5X return. 5.9% had a 5 to 10X return. 2.5% had a 10 to 20X return. 1.1% had a 20 to 50X, and 0.4% had a 50X plus.

[00:12:42] CP: Usually when you listen to the pitches of these, this is anecdotal, but they're looking for 10X return is what you often hear. They're looking for a 10 buyer. These are just absolute returns. You're not talking about any fees or carry cost here, right?

[00:12:54] BF: That's true. Yeah.

[00:12:54] CP: Because, I mean, a typical fee might be 2 and 22%, plus 20% performance fee, something like that.

[00:13:01] BF: Just on the idea of IPOs, Dimensional did a paper, they did a really good job with this one recently. They looked at IPO issues in the states going back to 1992 through 2018. They looked at it a couple of different ways, but one of the ways that I found interesting is that they built a hypothetical market cap-weighted portfolio consisting of IPO issues over the preceding 12-month period and then they rebalanced that IPO portfolio monthly. So you've always got the most recent IPOs in this IPO market cap-weighted portfolio.

They looked at the performance of that thing, and from 1992 through 2018 they found that the IPO portfolio trailed the market by an annualized 2.2% and they also found – This is actually their quoting from another Dimensional paper for this piece of sighting another Dimensional paper, but they found that the reason that IPOs have underperformed the market is because as a group, they behave like small cap growth stocks with low profitability that invest aggressively. So those are like the worst attributes as you can have as a stock. So that's what has driven those returns, which is interesting from a couple of perspectives.

It's interesting to note, but it's also interesting that the factors that we know that drive stock returns are also driving IPO returns, which I guess is reasonable to –

[00:14:13] CP: They overweighted factors that we don't want.

[00:14:15] BF: Those are the worst factors. In an actual Dimensional fund – First of all, they avoid new issues. So I think in that first 12 months they wouldn't own the shares anyway, but they also exclude those types of stocks, small cap growth stocks with low profitability that reinvest in the company aggressively. Those get excluded entirely from a Dimensional equity portfolio.

Then there's another study that they pulled from that paper that I thought was really interesting. They found that these are two papers that were in the Journal of Finance. Two separate papers. They found that IPO allocations with poor first day returns have generally been easier to obtain. So that's a negative pop. So it IPOs and then loses money. But IPOs with good first day returns. So you get that first day pop. Those had been harder to get. They've been reserved for certain clients of the underwriting banks. So I thought that was fascinating. Two separate papers from the Journal of Finance documented that.

So even though there might be a pop – There is. On average, there is a pop, but it's not so easy to get and you're probably not going to get it.

[00:15:16] CP: Yeah. Again, that interview Bill Gurley, talked about that as well, the pop. How they often price in the pop to create the excitement and demand for future IPOs.

[00:15:25] BF: Oh, they do it intentionally.

[00:15:26] CP: I'm not saying it's intentional, but that's kind of my takeaway. He quantified how much money is left on the table through this kind of experience through underwriting fees and also the pop. It's huge, huge money.

[00:15:37] BF: There's a funny interaction there going on between the company that's selling their equity shares to the public and the investment bank. The investment bank wants their

shares to go, which means they might push for a slightly lower price. The company wants to sell for as much as they possibly can. It's an interesting little dynamic going on there.

[00:15:54] CP: So one of the portfolio topic, and this inspired you, you're inspired by a regular listener who put a comment on the rationalreminder.ca website from last week's interview with Dr. Mascarenhas.

Again, great comment. I thought it was based on that pyramid that Wendell talked about that we shared on the site. The comment was that while I'm a huge fan of fact base decision making, it's important to remember that no one else had done in finance and investment field can measure up to the top rungs of the pyramid. So the pyramid refers to the power of information in making decisions. So the lowest level of information to make decisions in that pyramid was editorial or expert opinion.

In our world, that is often what shows up in TV and is treated with very high-regard. At the top of the pyramid are randomized controlled trials. That's the top of the medical pyramid for making decisions. So the comment goes on. For starters, you cannot run double blind studies or control studies format in financial markets.

Second, chemical, physical and biological systems tend to produce much more predictable and reproducible outcome than behavioral systems do. Lastly, while analysis of historical data are useful and instructive, I'm always reminder of the advice in once received from the chief risk officer of a very large bank, which was driving by looking through the rearview mirror is not ideal and can be fraught with risks. Let's make sure that we don't confuse Facts with a capital F with facts small F. As this podcast suggests, let's steer clear from alternative facts or expert opinions. This inspired you to do a little bit of thinking on this.

[00:17:27] BF: I was on this. I've been thinking about this actually because of the video that I did on dividend investing. There were a bunch of, as usual, dividend investors that came back with their rebuttals to what I'd said. A lot of them focus not on what I said or the part about factors describing the higher returns of dividend paying stocks, which is arguably the most important part of that whole conversation. But they actually attacked the dividend irrelevance theory itself. I thought that was interesting, because attacking the assumptions built into a theory doesn't really speak to how theoretical and empirical finance work. So I started thinking and

reading quite a bit about that, but that research led me to the book called The Fama Portfolio, which is I would call an ambitious read. It's a selection of Fama's paper throughout his career.

I mean, Fama's papers aren't exactly light reads.

[00:18:21] CP: Yeah. Put them all together, and wow, that is a brick.

[00:18:24] BF: Yeah, it is a brick. So the preface of this book, and it's written by a couple of guys that I think studied under Fama. One is John Cochrane who's still an economist at the University of Chicago, and the other one is Tobias Moskowitz. I think he's AQR, I think. Don't quote me on that though.

Either way, both highly intelligent people associated with Fama. So they wrote the book. But in the preface, they had some just gems of wisdom. So I figured it would be interesting to talk about. I may end up quoting from the book extensively. Well, this is a quote here. Here we go. They said, "Fama's contributions to finance are more like Darwin's than Einstein's. Evolution by natural selection is a simple sounding principle with a lot of hard thinking needed to make it useful.

That organized vast empirical project in biology. Without evolution, natural history would have just been a collection of curious facts about plants and animals. Efficient markets is a simple sounding principle with a lot of hard thinking needed to make it useful that organize the vast empirical project in financial economics. Without the efficient market hypothesis, empirical finance would have just been a collection of Wall Street anecdotes, how I got rich stories and technical trading new sheets."

That's fascinating to think about, because when we think about it in the context of the dividend investing debate, dividend stock is doing well alone. That's anecdotal. There's no theoretical reason for that to be true.

[00:19:47] CP: Absolutely true.

[00:19:49] BF: So when you start diving into what are the empirical data say? That can be dividend stocks doing well. That can be low volatility stocks doing well, small stocks doing well.

But in empirical finance, it's a matter of taking that initial empirical finding and trying to build a theoretical framework around it.

[00:20:06] CP: But in simple terms, it's like I'm just going at this with no necessarily horse in the race. Where if you look at the common feedback from a lot of the dividend people on your podcast, on your YouTube channel, it's like they had to prove that they're absolutely right.

[00:20:21] BF: There's probably bias in that academia too. People do want to come up with the next thing, and that's why there are so many published factors now even though a lot of them are probably just re-packagings of known factors. But I think that that concept of empirical findings are interesting, but without a theoretical framework to look at the empirical findings and then retest the theory in the data. The original empirical results aren't particularly useful.

In that same – And I'm quoting again now. But in that Fama book, they said, "Modern medicine doesn't ask old people for their health secrets. It does double blind clinical trials. To this we owe our ability to cure and prevent many diseases. Modern empirical finance doesn't ask Warren Buffett to share his paroles of investment wisdom as the media does. We study a survivor bias free sample of funds sort of from some X-antivisible characteristic to separate skill from luck and we correct for exposure to systematic risk. To this owe our wisdom, and maybe as a society as lot of wealth as well."

[00:21:20] CP: What a great paragraph.

[00:21:21] BF: It really is. Like I said, this preface was just full of nuggets of wisdom. But they also talk a lot about the challenge in distinguishing cause from effect. That's why I mentioned earlier that for any correlation, there are going to be multiple theories explaining it. I think this is one of the challenges that people have in understanding and thinking about the evidence when it comes to economic sciences in general probably, but financial economics in particular.

But I think that in a lot of ways, that's not a weakness of financial theory. The fact that we'll never know if it perfectly explains the outcomes that we see. I think it's actually a strength, because you take something like the efficient market hypothesis where it's like things might work this way and then you can go and test that. It's not so much about proving or disproving market efficiency. I think that it's pretty widely accepted that markets are not perfectly efficient.

Even when Fama proposed market efficiency in 1970, he wrote in the paper he doesn't expect markets to be perfectly efficient. That's an ideal state that real markets can only approach. So it's interesting to think about in the context of the ongoing debate around market efficiency. Are markets efficient or not? That's almost a wrong discussion to be having.

[00:22:29] CP: Here's a paragraph from that same excerpt. Efficiency and finance means information and only information. Informationally, efficient market can suffer economically inefficient runs and crashes. So long as those crashes are not predictable.

[00:22:44] BF: Yeah. They talk in that book about people will often say, and I've heard this many times, that the crash in 2008 proves that markets are inefficient, which I don't think makes a whole lot of sense.

[00:22:53] CP: No. Shows how fast people change their opinion and their risk appetite based on the world of exchanging around them.

[00:23:00] BF: That's exactly right.

[00:23:00] CP: It changed so fast. You could argue that it's highly efficient.

[00:23:04] BF: I totally agree. There is information in prices, but that doesn't mean that the information is going to be known ahead of time. It just means that current information and expectations are in prices at a point in time.

[00:23:14] CP: Exactly.

[00:23:15] BF: Anyway, I think that the conversation also often gets lost when we start talking about the evidence in financial economics, where when we talk about index funds making sense, when we talk about prices reflecting information and things like that. The debate turning to is the theory right is entirely the wrong discussion to be having. The theory is the theory. It's not right or wrong.

© 2019 Rational Reminder Podcast

I think in the same book, I didn't note this one, but one of the other things in the book that they mentioned was about Warren Buffett. They said when someone asks, "Yes, but why did Warren Buffett get so rich?" The real answer is just, "Sir, that's a poorly post question. Why did Uncle Joe not get cancer even though he smoked his whole life? Medicine is useful, though it does not answer such questions." We recognize that this is unsatisfactory to journalists. Sadly, many academics do still offer X-posts stories from market movements on morning TV shows.

Anyway, I think that this whole discussion of what does the theory mean? What does the theory even say? Which I often think gets lost in the whole conversation. But what does the theory mean to decision making? That usually gets lost in the whole discussion. People will make sweeping statements like markets are not efficient. Therefore, you should do something different. But I think that's the wrong conversation to be having. The theory is the theory. All we can do is test the theory with the empirical data, which we do, and that kind of informed decisions.

At the end of the preface of that book they say, "Gene Fama's bottom line is always look at the facts. Collect the data. Test the theory. Every time we look, the world surprises us totally and it will again."

[00:24:50] CP: That's Gene.

[00:24:50] BF: That's Gene.

[00:24:51] CP: Are you good to go into the planning topic?

[00:24:53] BF: Yeah, I think so.

[00:24:54] CP: So planning topic, this is one that I came up with this week. It's a chart that I saw somewhere on Twitter last week that looked at the clustering of times for people who completed a marathon. So I've done two marathons and a bunch of half marathons, and you do train to a time. Then once you're in that event, you're managing your time to try to get to your goal.

So when you look at this chart, it just shows how many more people that you'd expect end up finishing, say, a 3.5, 4 hours, 4.5 hours, or 4:50, whatever your time might have been. So it just shows you that to do a certain time, it's all about training.

So whenever someone has said to me, "Oh, I can never do a marathon." "Yes, you could. You just don't want to put the time into training," right? Some people may not be physically able to, but most people with proper training can do a marathon and then, "Well, my goal is just to finish it." Well, no. You should pick a time. If you want to do 3.5 hours, that's a much greater amount of training than to say do 4 hours or 4.5 hours, right?

So it just got me thinking about this whole goal setting in retirement. So I went and looked around for another study on marathons. I found a really interesting one that tracked 2.9 million runners' data for the 5 years. In 2017, covers 196 marathons, 784 different events, 238 nationalities, 39 countries, 7 continents. So it's a huge cohort of runners. Guess what the fastest age group was overall. Age for 40 to 49 had the best time, even though that's not the youngest. That's arguably not the healthiest cohort. So I thought that was really interesting how I guess you have to be at a certain point in your life where you want to set goals perhaps.

So I started thinking about, because I saw this as I was going to see a client last week who for the past 10 years has set 2020 as their retirement years. Partnered with us to make sure we knew the math and what it would take to be on track for that. They went back and went through all their expenses and cleared up all the stuff that wasn't necessary for standard of living in their retirement. So they worked on their side. We worked on our side. Now we're five months away from it being a reality.

It just got me thinking about you have to be in the right frame of mind, the right time of life perhaps to be able to set your goals, whether it's retirement, whether it's a marathon time. But then once you decide on the goals, so you picked a time, be it four hours to finish a marathon or retire on 2020, once you're in it, you keep focusing on that time.

So we talked about this 2020 time all the way long exactly like when you're in a marathon and you just keep – Every six months, we just stay on track to make sure we're on track to be able to reach that goal. So it all did come together.

© 2019 Rational Reminder Podcast

[00:27:29] BF: So I've never been interested in setting goals, and that may sound weird. I've always like doing as well as I can at stuff, but I've never sat down and decided this is what I need to do to get there. Maybe I'd be doing better in life if I had been doing that. But I've never set goals. I just do the best I can and every day I wake up and I look at the information that I have. I look at what my situation is and I do the best that I can with what I have.

When it comes to financial markets, what do you think about the idea that if you set goals and you do everything in your control to achieve those goals, you can still get smoked by the market? In the client that we're talking about now, what if the market crashed 50%?

[00:28:07] CP: Yes. I mean, we built the model and it's a balanced portfolio. We built it in with Monte Carlo randomization on returns. We've done everything possible. That still can happen for sure.

[00:28:17] BF: Yes, it's just interesting to think about.

[00:28:17] CP: The difference in this kind of planning though versus in other facets of your life, there're certain constraints, right? If you want to do a great time in running, if you had the time, you could perhaps train four hours a day like people do to run an ultramarathon or some sort of ironman type event. So there are certain constraints. If you want to retire early or, yeah, you'd love to say 100% of your paycheck. Well, meanwhile you've got kids and homes and other stuff to pay for. So it's within constraints, right? That's why I think this is a little bit different.

[00:28:43] BF: Yeah, it's just interesting to think about. I guess it's kind of like training really hard for a marathon and you snap your Achilles tendon the day before the race.

[00:28:52] CP: I guess that would have been a better answer, right? Stuff happens.

[00:28:55] BF: Stuff happens, yeah.

[00:28:56] CP: I thought about Michael Kitsis, who's an avid podcaster and researcher in our business. Talks about coming out the retirement planning from both sides. His rule of thumb is for every thousand dollars of annual spending, you need $30,000 of savings. If you think of everything like that, you end up focusing, yes, on the savings side, which everyone knows

about, but also on the spending side. If you're spending $10,000 a year on car payments, you need $300,000 in a bucket to finance that in perpetuity in retirement. So I thought that was an interesting way of looking at it too.

[00:29:29] BF: That is a really good way to look at that thing. I like that.

[00:29:32] CP: So bad advice of the week, unbelievable this one. This comes from the Investment Executive, which is a periodical that's targeted to investment advisors, the October edition talked about how the Canadian Securities Administrators have issued a couple of major policy initiatives. One of them was to band the deferred sales charge. We've been talking about this in our business for what? 7 to 10 years, I would guess, about how an industry is saying the same thing. It should be going away. But the quote in the article todays said looks like the ban isn't officially dead, but it's on life support, which is just stunning to me.

The OSC, the Ontario Securities Commissions says that the deferred sales charge issue on their agenda as part of their annual statement of priorities. But they're coming up against the Ontario government, which is opposed to a ban on the deferred sales charge.

[00:30:20] BF: Even though this thing isn't going away in the legislation, it's going away in real-life. Investors Group, who they're a huge player in the DSC world, or they used to be, they've stopped it.

[00:30:30] CP: A long time ago.

[00:30:31] BF: Yeah. Well, a year ago, right?

[00:30:33] CP: So I tried to find some data on how much money is going to backend load funds. I couldn't find any data, so I have no idea. Do you?

[00:30:39] BF: I can pull it from Morning Star. I don't have it front of me, but we can talk about that next time.

[00:30:43] CP: But I can imagine it being very much.

[00:30:45] BF: It'd be interesting to know how much is still going into DSC funds.

[00:30:48] CP: Deferred sales charge, when you buy into a fund and it pays a commission to the advisor, what? 4% to 5% I would guess? Then you're locked in for 5 to 7 years. So you end up in typically a higher expense ratio fund, which is what is partially financed in that commission upfront of the advisor.

[00:31:04] BF: You know what the really messed up thing is? We talk about this and we talked about how bad DSC is. Do you remember awhile back, we talked about those annuity products in the states? It was a DALBAR study. It's kind of like the behavior gap story that we talked about today. These brutal high-commission, high-fee annuity products that are being sold in the states ended up with better investor returns than a lot of mutual funds.

[00:31:29] CP: Because it was a behavior modifier.

[00:31:30] BF: Because you're stuck in these products. You got to wonder. That'd be interesting to look at the investor returns. We don't have that data for Canada, unfortunately. At least not that I know of, but it'd be interesting to look at the investor returns of deferred sales charge funds versus ETFs or something, if you could get that data, which you can't, because there's that whole argument about what is the value of advice? With the DSC, I mean, you're tied to this person who sold you this product and neither them nor you want you to get out of it. You got to wonder, what is the actual impact –

[00:31:59] CP: You're not tied to the person. You're tied to the product the person can go, because your frontend loaded on all these. You're basically to sell. Not paid to serve.

[00:32:07] BF: But they're still getting a trailer.

[00:32:08] CP: Small trail for sure.

[00:32:09] BF: So they don't want you to pull your money out. I'd be curious to know what that data would say.

[00:32:14] CP: I remember, we did backend load funds back in the 90s. Just nuts.

[00:32:18] BF:

[00:32:18] CP: $100,000 purchase would get you $5,000 or $6,000 commission.

[00:32:23] BF: Wow!

[00:32:23] CP: Yeah. Didn't feel right at all.

[00:32:25] BF: I think, today, the environment is a lot different in Canada and probably elsewhere too, but we have a lot more choice in terms of getting advice from somebody for a fee, like pay a thousand dollars or whatever to go and get some financial planning advice to help you figure out what to do in terms of financial planning and things like that. But even then, if you go and panic sell out of Vegrow or something. You can still do that very easily if you have –

[00:32:51] CP: Maybe what you need is you have to buy Vegrow with a lock up provision on it. Forget the commission, but just put a lock up on you.

[00:32:57] BF: I think Cliff Asness or [inaudible 00:32:57] or somebody on Finance Twitter said something about that, that they think that would lead to better investor outcomes, but the regulators didn't like the idea or something. They're making a joke.

Anyway, behavior is so important.

[00:33:10] CP: Cool. Anything else?

[00:33:11] BF: That's all I got.

[00:33:11] CP: All right, thanks for listening.

[END]

The ideas, opinions, and recommendations contained in this document are those of the authors and do not necessarily represent the views of PWL Capital