Financial Detox Podcast
Episode #128
Stock Picking Versus Evidence Based Investing

[EPISODE]

Jason: Hello. Welcome to the Financial Detox Podcast. I'm Jason Labrum, your host, with my co-host Alex Klingensmith and we're in the Intelligence Driven Advisors studio in Carlsbad, California. We're doing a podcast live from our studio. Oops. My phone is vibrating.

Alex: We are and we're just talking about what it is. So, last Saturday, June 1, first day of June, we had a radio show that aired on KCBQ and we talked about stock picking versus evidence-based investing, I've been calling stock picking conventional investing, conventional meaning like my grandfather…

Jason: I love the way you do that.

Alex: Like my grandma's in an investment club.

Jason: And they pick stocks. They go, "Ooh, I love Walmart. It's going to be good."

Alex: Dogs of the Dow, they bought Alibaba after it had peaked. They know their performance is not great but it's a fun hobby and they do it based on the conventional way, literally, they research individual companies come together as a group and talk about them over tea or whatever and they buy stock. They manage a million bucks.

Jason: No way. They buy at the top and they sell at the bottom.

Alex: They buy randomly and sell randomly but it's fun and it's conventional investing. Now, evidence-based investing is the alternative that we are proposing.

Jason: Wouldn't that be more fun for them if they got together and came up with phenomenal baskets of stocks and ETFs and mutual funds that actually had great performance? And then imagine like the grandma fund where they run a hedge fund diversification fund of funds and they crush all the indexes and then they're like on TV and they did GrandmaInvesting.com and all kinds of stuff.

Alex: This is a hobby, I think. It's like mah-jongg and investment community.

Jason: I want to start a business out of it.

Alex: The grandma fund?

Jason: Grandma fund.

Alex: Oh my gosh.

Jason: There's got to be like a theory behind that like the monkey theory, monkey throw darts, grandmas pick good stocks.

Alex: So, on our radio show there are three things. We propose three different studies separate in all the different and interesting, not that grandma fund was not one of them, but one of them was Buffett bet. The other one was the monkey study. And then the third one was the DALBAR quantitative analysis.

Jason: Well and I've got a fourth one on here. It's going to surprise on you.

Alex: How cool.

Jason: [Started singing] Because I drop my bombs on you, baby.

Alex: It was not on the radio show though. I don't know what that is. What are you showing me?

Jason: This is the Investment Company of America which is an American Funds brochure. American Funds is a mutual fund company and it just has some interesting stuff about, well, we don't use very many American funds although they're not bad. They're good funds but it's kind of cool telling the story so we're going to talk about it.

Alex: American Fund story is the fourth one. Okay. Yeah.

Jason: But the monkey one I think we basically just argued ourselves out of even talking about that before the show.

Alex: We already talked about it on the radio show. We can't just omit it.

Jason: Well, monkey throw darts and they did better than the benchmark because they ended up with small-cap stocks. So, here's a problem with most benchmarks and index.

Alex: It's a terrible recap but okay.

Jason: No. I think it was great.

Alex: What is? That's not even the right monkey story.

Jason: It wasn't? Which monkey story were you talking about?

Alex: The one that I saw at Dimensional. You were probably there with me. You helped me. Your monkey story was not really supportive of what we're trying to prove here. I get that but the one at Dimensional said, "Listen, if there's 10,000 stocks...” How many are there in the world? 15,000 or something?

Jason: There’s a lot.

Alex: Publicly traded stocks you can buy and if you put them on the wall and you had them all the same equally calculated…

Jason: Oh, I know what you’re doing.

Alex: Versus large capitalization.

Jason: I love this. So, there’s two monkey studies.

Alex: Probably more than one or probably more than two but this one is they throw darts random monkeys. Literally, they took them and put them in a focus group, these monkeys. They fed them. They took really good care of the monkeys. They had them throwing darts and then they track performance of the choices that they randomly…

Jason: Did the monkeys actually throw darts or did they simulate what would've happened?

Alex: I wasn't there.

Jason: I don't think the monkeys threw the darts. I don't think they really had monkeys throwing darts. First of all, can a monkey throw a dart? Technically, their hands, are they capable of throwing a dart? I mean, so is it the monkey study which… Oh man, Alex went into bed. We’ve never had a show where we just laughed. Oh boy. It’s been a long week.

Alex: I don’t know but either way allegedly in the study they had some way to show this happening. So, Dimensional is a pretty well respected evidence-based, research-based investment fund management so I don’t think they get up and talk about it if there wasn't some sort of way to prove it. I can get you the study if you want, you know, email us, jason@financialdetox.com.

Jason: I think we’re delirious because you went to bed at 12 and woke up at 4 and I'm just delirious because I'm tired.

Alex: No, it's great. So, there’s two monkey studies. Let's go into the Buffett one because that one is a little bit more clear path on what happened.

Jason: Yeah. Exactly. We know there's a man named Buffett and we know that he made a bet.

Alex: He bet the hedge fund industry 10 years ago that he bought the S&P 500.

Jason: Yes.

Alex: He put $1 million on the line, $1 million of real money from Berkshire Hathaway.

Jason: American dollars.

Alex: And he said, "I bet you guys," this is back in '08, "I bet you that I will outperform you with this S&P 500 index over a ten-year period." And after nine years they surrendered. They just quit. They were so far behind and they just couldn't come back.

Jason: Well, you know what it makes me think of is that article we have, which if you want to get that. By the way, if you want to get a hold of us, it's 877-707-8889. If you want to call us, give us a call or check us out at FinancialDetox.com. Okay. So, the study that talks about the hedge of darkness and it was also put out by DFA I think but it shows how if you want to pay millions in fees and lose money, you invest in hedge funds because their game or scheme is to be wiser than the market and develop strategies since very sophisticated strategy so they have to charge you tons of money 2% and 22.

Alex: They are sophisticated strategies. It's confusing complicated stuff.

Jason: And the sad fact of the matter is none of them outperform the benchmark really unless we're in an extended down period. So, they outperform during a bear market sometimes, but then they lose so much on the upside and it never works.

Alex: Those are harsh words "never" and stuff like that.

Jason: That's true because there are some really great performing hedge funds over long periods of time.

Alex: I think Buffett just really – he's basically put his money where his mouth is, and he even has the advice he's given to his next generation of his own family that when you inherit this vast amount of wealth…

Jason: He told them to hire Intelligence Driven Advisor.

Alex: Not yet.

Jason: He set to buy index funds. He literally meant that but I hope he doesn't because if they buy capitalization-weighted index funds then my monkey story starts to make sense because my monkey story will tell them they shouldn't buy the capitalization-weighted index funds because it's not the best way to invest. In fact, I think that if you have an advisor who is just buying straight index funds that you're actually that's not good. You're at a disadvantage to even some but if somebody did the stock picking perfectly, which they won't, but if they did stock picking perfectly, they would beat the index fund because they would end up with lower cost, lower taxes, and they would also end up with smaller cap portfolios. So, let's explain that though because we're on a podcast here and this is fun. We have time. We don't have to take a break in three minutes. Capitalization-weighted index so the S&P 500, the NASDAQ 100, the Dow Jones 30, those are capitalization-weighted indexes where the largest stock in that basket of stocks gets the largest weighting.

Jason: Microsoft, Apple, Amazon, Google, they end up with the large percentage of the total portfolio so your portfolio if invested in a capitalization-weighted traditional index is overweighed towards large-company stocks. You don't have a lot of small company stocks where we know that historically small company stocks and particularly small company value stocks have significantly outperformed the larger cap stocks. The number from 1928 is $1 invested gross to I believe it's 4,700 in large-cap stocks, the S&P 500, and invested in small-cap value it grows to 77,000.

Alex: Sure. And the reason being because large companies have already experienced most of their growth cycle already. Amazon is not going to triple in size probably compared to a tiny…

Jason: Maybe not as well.

Alex: Okay. Well, whereas like a Dexcom has tripled in size in five years. So, like that there's more upside potential there. That's the reason being for that, right?

Jason: Yes.

Alex: And then value versus growth, that's the monkey thing, but so Buffett said…

Jason: Oh, Buffett.

Alex: I mean, so he's saying these hedge funds you're talking about that are individually picking stocks that are tiny markets predicting the future, I think I can do better by buying I call them dumb indexes. No offense to them but a dumb versus smart versus…

Jason: Factor based, yeah.

Alex: Versus smart data. They actually call them smart data, right, which is what we would prefer to use anyone.

Jason: I like smart index and so we have a trademark on that.

Alex: That's a good one, yeah.

Jason: Okay. So, let's talk about - so what are we talking about? We are talking about whether you should be trying to pick individual stocks or whether you should be buying a general index or whether you should be buying a smart index or a factor-based portfolio, or whether it's some combination of the bunch of them, right? The problem is which we talk about all the time and I don't want to sound like a broken record but the problem is most people make gigantic behavioral blunders when it comes to investing. That's why we created Financial Detox and they make mistakes which detract from their long-term rate of returns in a huge way, in a way that is meaningful and erases wealth from them and their families.

Alex: I mean, DALBAR proves this 25 years in a row that come out with this research report that we oftentimes drop lots of pieces of this report. We actually have it for the podcast if we can be specific on the design but more evidence so we like evidence. We like to say, "Okay. Look, why do we…" Well, people ask us like, "Why do you do it this way?" We just wrote our newsletter on that. Why? I'm just checking you out for the first time like I get it but I'm comfortable with what my grandpa used to do or my dad or what I'm used to as buying Qualcomm or Chevron. Whatever. Cool. Well, why would I do it your way? Well, because if you don't, here's like two or three evidence research. There are things that are going to show you're probably not going to do as well. And DALBAR explores it and they point all the way back to the behavior. We go way back and then even looking at like to behavior when we have very specific behavioral things that we can talk about a little bit if we want to get into it on this show.

Jason: Yeah. Let's talk about some.

Alex: I mean, even in 2018 the average equity fund investor underperformed the S&P 500 by 504 basis points.

Jason: 5%.

Alex: Yeah. In one year, they underperformed by 5% so average stock, funds, so people with and without…

Jason: Right. Negative 4.3 for the S&P 100 versus negative 9.4 for the average fund investor.

Alex: So, the study talks about people with and without advisors buying stock mutual funds.

Jason: And that's a problem is, okay, so then if I had a global equity fund portfolio, sure I'm down more because international was down more last year. But when you look at this over longer periods of time, the data to me becomes more reliable because, over a longer period of time, a global equity portfolio should do better than the S&P 500. We know it has but yet investors who invested in funds did not do as well even as the S&P 500, let alone that they do as well as a global equity portfolio. So, that's a crazy time. So, let's talk about the emotions, the things, the behavior. So, they call it investor psychology in the report, which we refer to all the time. A lot of times it's referred to as behavioral finance. So, what are the mental things, the behavior or the psychology that can cause you to mess up? How about loss aversion? So, expecting to find high returns with low risk.

Alex: That's easy, right?

Jason: Oh, my gosh. How many times do we see that?

Alex: Big points.

Jason: Right. Expecting to find high returns. We had a client today who is in the office and talked about, “Well, I just don't like the risk. I'm concerned about the market,” and then in the same breath, he said, “I would like to get higher returns. I need higher returns.” You actually don’t need higher returns. Your plan’s doing great with the returns you are expecting to get right now, but literally, he said, “I want higher returns with lower risk,” in one sentence.

Alex: Did you tell him he was a loss aversionist?

Jason: I didn’t go there. Narrow framing is another one. Making decisions without considering all implications. People do that all the time with real estate, which we did a show on today where they say, “Oh, real estate is always great. It always goes up,” and they go and buy it and then they don't think about the fact that they’re going to have maintenance on that property. They don't think about the HOA or they don't think about, “Oh, I got to pay a property manager,” or I got to answer the phone at 12 o'clock at night when the plumbing starts leaking and that would be a narrow framing. How about mental accounting? Taking undue risk in one area and avoiding rational risk in another. I love that one. Here’s that I’m going to buy an annuity that's principal guaranteed because it sounds so good and safe but yet my average annual return is going to be 3% as opposed to 8%.

Alex: You’re paying for the risk.

Jason: Or paying for the insurance, yeah, around the risk. These are interesting but this we could go on. There's about 11 of them so call us and get the report if you want. Check us out, FinancialDetox.com.

Alex: Yeah. How many pages is that thing?

Jason: Let me count. One, two…

Alex: No page numbers?

Jason: No. It’s 11 pages.

Alex: Okay. Eleven. I think I said seven so it wasn’t that far off but it’s not daunting, the 40 pages of a bunch of pictures and things. Well, there’s some big pictures in there so it’s like seven pages of actual reading, but it's worth reading for like the 20 minutes it would take to read it because it'll basically force you to be honest with yourself. If you're thinking about either hiring an advisor or you’re already working with an advisor who does engage in conventional investing, I think it's a really powerful piece of evidence to support why you shouldn’t do that.

Jason: Well, I think the best piece of evidence is not only this, because this shows you why even mutual fund investors, this shows why investors make mistakes or why investors perform poorly. It doesn't really specify why picking stocks. What specifies why picking stocks perform poorly which we have is, is looking at how the best mutual fund managers in the world. So, these are the stock pickers, how they have performed versus the broad benchmarks. So, we can show empirical evidence that the best money managers “stock pickers in the world” don't outperform their benchmarks. In fact, there are some studies through SPIA, Standard & Poor's Index Association, that will show that if you take all the mutual funds that beat their index over a 10-year period and then keep them in their exact same category and make them continue to do what they are supposed to be doing and they said they did the first 10 years that less than 2% will actually outperform the index, the subsequent ten-year period.

Alex: And the first wave was 85% purchase or something, right?

Jason: 15% outperformed.

Alex: 5% actually did better than what they're supposed to.

Jason: Yeah. On the first run which can purely be attributed to luck and then the subsequent 10 years is 2%, which could actually be attributed to luck again. So, 85% and 98% don't outperform the events.

Alex: Those are worse odds than getting into Harvard or something.

Jason: These are supposedly the biggest research institutions in the world that think they have the greatest minds and they can pick stocks and they actually don't outperform. Here's another one. Here’s a cool one. So, basically, I see American Funds, a stable tried-and-true mutual fund company. They do a great job. I don't think it's the best solution, but I think it's a very good solution in a lot of situations, but they took the Dow 30 and they basically had you pick out on a sheet. You could’ve invested it if you could have. This is with hindsight. $10,000 in any five of these companies 73 years ago, which ones would you want? And you kind of go through and say, "What have you done?” And it's very interesting that any one of the companies individually underperformed the whole of them but yet if you put them all together and you bought the basket or if you had a whole basket of securities, you performed second. There was only one pick out of 30…

Alex: Who won?

Jason: Altria, Big MO. Cigarette company.

Alex: Elk.

Jason: Yeah So, anyway, it was the best performing and this is a few years old but that was the best performing stock over that 73-year period. And so, even though you would’ve picked from all these stocks and they all look like great companies and great names, only one of them outperform the broad benchmark of a diversified portfolio.

Alex: So, they're making the case of buying a mutual fund versus individual stock picking. It's interesting because that they're known, I think correct me if I'm wrong, but American Funds is known as an active fund management company, right?

Jason: They are but they become so big, they're almost an index because they're just huge. They have a hard time I think moving positions because they have such big positions.

Alex: Yes.

Jason: But, yes, they are an active money manager but they're also not one who tries to chase hot dogs. They talk about their tried-and-true philosophy and time-test it and that they stay disciplined in structure.

Alex: I like that. I mean, they have a reputation that's coming up as maybe a more active fund management so they're not only trying to prove the point of being diversified in a mutual fund structure, maybe, but also that you can even pick them in with hindsight, so don't try.

Jason: It doesn't work. It's not going to work. You're not going to outperform by picking individual stocks. So, I think that's the point is that there's an easy way to do this and I guess it depends on what your goal is. If you're trying to create financial peace of mind and results then you seek out the most data-driven evidence-based way to proof. Well, how can I stack the odds in my favor, right? If you're really seeking results, if you're trying to become a great poker player, you're going to figure out how to stack the odds in your favor and then you play a lot of times and you end up winning. Where in investing, we play every day, we stack the odds in our favor, and if we do that the right way long enough, we're going to come out doing really well because we're stacking odds in our favor which is the same thing as saying create, use evidence-based investing and data-driven. So, we believe that you can and will do better by having a basket, a diversified basket, but you have to focus on controlling costs within that. You have to focus on controlling tax within that. And things have changed. Your grandfather's mutual fund was one that had a 2.2% internal expense that was terribly tax inefficient and that's why I think they have such a bad rap.

However, the new school version of in current modern the right type of funds can be smart index based so they're getting you exposure to broad markets, not in a capitalization way like we talked about at first of the show but instead of a fundamental way.

Alex: And the cost of actually…

Jason: Come down dramatically.

Alex: Yeah. If you know how to focus on what you're supposed to focus on and not get caught up in the bright shining lights of… There are some fund companies out there I heard today there is a negative fee ETF.

Jason: They'll pay you to have your money.

Alex: No, I'm not kidding and it's going to be that way until they reach a certain AUM or whatever of the fund. Maybe the first billion or whatever. I don't know what the number is but it's negative. So, Fidelity came out with a zero. It's really zero internal expenses, right?

Jason: For like S&P 500 fund or something.

Alex: So, there's so much decompression. Now, how can they afford to do that? That's what you always have to ask yourself if you're an investor like, okay, cool. So, I'm going to listen to Jason on Financial Detox broadcast. I'm going to buy the zero or the negative stuff, really the one they pay me for but wait a minute, what's really going on there? And how can they do that and what other stuff are you going to get caught up in? So, the first step…

Jason: Well, and also, do you even want that capitalization-weighted index because I would recommend you don't. I'd recommend not.

Alex: Step one is kind of accomplished though that we've gotten you over the hurdle of like maybe not picking stocks and timing markets is the best thing. Step two is, okay, getting once you're there then which ones do you buy? Even if they're really cheap and low tax, are they still the right? Is there something else hidden in there? And step three would be then figuring out the asset allocation within those options. Step four would be what is the right one for you and your plan?

Jason: Yeah. Exactly.

Alex: Right? Well, what is your plan? What is you? Not everybody, but was your life how much risk do you need to take?

Jason: Yeah. And if you want a side account that you do the grandma, the monkey, the mad money, the gambling thing, you just do that on the side because it's fun, don't mess with your real money and your large chunk of money with doing that. So, I think you summarized it well. I think we can go home.

Alex: Okay.

Jason: What do you think? Drop the mic.

Alex: Actually, they're on little stands. We can't even do that. You can't drop this.

Jason: We could throw them over.

Alex: No. Let’s just leave them. Maybe for next time.

Jason: All right. So, Financial Detox, we are here to help you make better decisions. We’re here to help you purge yourself of the behavioral blunders that most of investors make, destroying their long-term rates of returns and just helping you do better personally and financially for yourself and your family. We’d love you to check us out online at FinancialDetox.com. You can check out our radio show also FinancialDetox.com. You can listen to it on KCBQ AM 1170 or FM 96.1. That's San Diego, The Answer, and our show’s on Saturday at 1:30. But it's easier just to grab it with no commercials on the podcast at FinancialDetox.com. So, I’m Jason Labrum, your host. Thanks for listening. Feel free to give us a call anytime. We’d love to help you as the Financial Detox team at Intelligence Driven Advisors and signing out here with Alex. Thanks, buddy, for all your time.

Alex: Yeah, man.

Jason: We’ll catch you on the next show.

Alex: All right.

Jason: Bye.

[END]