Episode 58: Do the Investment Pros Outperform the Market?

Bob French 00:00
The purpose of Retire with Style is to help you discover the retirement income plan that is right for you. The first step is to discover your retirement income personality. Start by going to risaprofile.com/style and sign up to take the industry's first financial personality tool for retirement planning. Generally, when you pay someone to do something they're supposed to know what they're doing. So what are we paying money managers to do?

Alex Murguia 00:52
Hey everybody welcome to Retire with Style we got the three amigos here or two amigos I want to

Bob French 01:02
Wade I'm sorry. Apparently you've been down graded.

Alex Murguia 01:07
Myself I'm having trouble. Yeah, I didn't read my affirmations today. So you know I'm just attaching myself today. Alex we got Bobby French. I don't think I've ever referred to him as Bobby by the way. And Wade Pfau How are we doing today? Jan's

Wade Pfau 01:30
doing great doing great.

Alex Murguia 01:32
Come on Wade we need a little more enthusiasm. How are we doing today?

Wade Pfau 01:35
I'm pumped to talk about performance of managers.

Alex Murguia 01:40
That's as good as it gets. And that's why we love him.

Bob French 01:45
I'm doing doing well. I actually I'm pumped to be talking about manager performance. This is this is a fun topic. So I don't know that I've ever been quite that pumped.

Alex Murguia 02:02
And this isn't an investment. We were speaking and we were having a little chit chat before the podcast to change the face but the story was too good. And Wade Wade said hold it. That's gold. We need to put this Wade do you think no one believes me, by the way.

Bob French 02:22
Let's cut that short. What Alex is talking about is so I think I think it was last time we might have in the time before we were talking about how I've never seen godfather. Wade, I don't believe you saw Godfather either.

Alex Murguia 02:40
Yea he has.

Bob French 02:43
But my taste is more towards this weekend. My wife and I went to go see cocaine bear. And I will say it is it is exactly as awesome as you think it is for good or bad. You know exactly what it's about. But, but yeah, it was it was a lot of fun. So

Alex Murguia 03:06
what happened? What's it about? Is it like Snakes on a Plane? But with bears?

Bob French 03:11
you know, it's a very sedate kind of nature documentary. It was.

Wade Pfau 03:22
What was that about real life?

Bob French 03:23
Yeah, the the real life bear didn't go around killing people, I guess, fortunately. But they did find the bear after it had OD on cocaine. And then they stuffed the bear. And for a long time it was hanging out in a mall in I think it was Kentucky. Just kind of chillin. Of course. Yeah. And then Waylon Jennings owned it for a while I which is appropriate, by the way that there's a group of people who if they knew that a bear who Odede on cocaine was stuffed, sitting in a mall somewhere. They're definitely going to buy that and while

Alex Murguia 04:12
it doesn't say if that didn't say outlaw country

Bob French 04:17
I don't know. I don't know where it is now. But yeah.

Alex Murguia 04:23
Now a little unknown fact about Wade. You're talking about cocaine bear. Are you talking about? Wade, he can recite, Cheech and Chong up in smoke from first scene to the last. No, not at all. Wade may say we may need to edit that.

Bob French 04:49
Leave that one actually.

Alex Murguia 04:53
Just think it's plausible. No. So, so what are we gonna laugh at today?

Bob French 05:09
Yeah, so today, um, you know, we've kind of been talking a lot about kind of the different styles of kind of market analysis that are out there. So we talked about technical analysis, the one with all the weird charts, fundamental analysis, the one with all the weird spreadsheets, and then market timing, which is kind of the, you know, the the lazy way of doing it, if you will, kind of the everyone knows type of thing.

Alex Murguia 05:40
I disagree. Technical analysis, probably the lazy way. Fundamental is kind of maybe a little over, you know, over the top and market timing is in between that

Bob French 05:51
We can go with that taxonomy there.

Wade Pfau 05:53
It compromise.

Alex Murguia 05:57
What're saying, But Wade, what are you saying?

Wade Pfau 05:58
a compromise.

Alex Murguia 06:00
Yeah, exactly. Exactly.

Wade Pfau 06:02
no clear framework.

Bob French 06:04
Exactly. But today, what do we wanted to kind of take a look at was, you know, the professional managers out there, you know, what are they doing? You know, they're making a lot of money, doing this type of stuff. So you would think that they must be doing something, you know, people are very clearly very happy to pay for them to do these sorts of things. So, does it make sense? You know, are they actually providing real value to their investors? So the people putting their money with them?

Alex Murguia 06:43
Can I Can I ask you to something? Because this is, and this has to do with this? And I think it sets us up as well. From a contextual standpoint. I didn't like my formal education was not in this field. All right, Bob had a foggy four years. So I don't know if he can answer this. Now. His his his, his thing was, you know, he was in this field, you know, but But you know, just all his life really? And wait, you were in this,

you know, PhD in economics. So you are there was always this sense of it. I think, for the the the uninitiated, if you will, I think it's fairly logical to think there is an entire educational system geared towards, you know, developing fine young people to be able to, to, to bestow on them these analytical skill sets to be able to do such and such,

Bob French 07:38
yeah, to the point Wade I actually have that. Wade and I have actually done it.

Alex Murguia 07:43
none of it put. So it's, but it's fairly, it's fairly reasonable for a consumer to think, you know, they listened to our technical analysis, they listened to our fundamental analysis podcasts, they listen to us, our market timing podcast, and even after all of that, they could still like, Yeah, but guys, there's professionals that get paid million plus dollars to do this. And you can't tell me that the king has no clothes kind of, kind of story to and it just can't be, there has to be this value that's being like that. That's, that's, uh, that's where, if I'm listening to this, like, new, I'm thinking that like,

Bob French 08:24
entirely, I mean, it's, it's baffling. That, you know, we can go through and say all these approaches don't work. But the financial service industry is still, by and large, entirely devoted to doing this at least on the investment side.

Alex Murguia 08:44
So is, is it possible that my degree in film was more useful than a degree? And I don't know. fundament fundamental analysis for stocks? Because at least I enjoyed watching movies during those four years, is what is that?

Bob French 09:02
What we were saying about fundamental analysis? You know, who are you providing that value to? You know, it's, you know, it doesn't seem to be and, you know, we'll talk about this as we get into it. But, you know, one of the nice things about looking at kind of fund managers, you know, in the public space of mutual fund managers is, we have really good data. You know, because of all of these reporting requirements, we can actually go in and see, okay, here were the returns on all of the funds that were available. Yeah. And we can see, we can see what actually worked what did it how did these people actually do? And you know, the results not looking so hot?

Alex Murguia 09:55
Yeah, this goes back to the phrase that I like, my stats Professor kind of phrase He says, gotta we trust everyone else bring data? Or is it? Or is it Wade is a datum, or data in this case?

Wade Pfau 10:09
Data. But yeah, a number of Uber drivers over the years who've talked about how great investors they are, and there's no way to really verify their past performance. But we can do that with professional absolutely insurance. And that's an important part of today's show.

Alex Murguia 10:27
And I don't want you to think of this, like in other professions, try to make analogies in your head. Imagine if we had data on successful surgeries, successful knee replacement surgeries, right? That would be a good barometer of an orthopedic surgeon, right? who specializes in knees, etc. Right? That would be the same criteria, you would you would say, you were you would ask for? Well, how many, you know, what's your hit rate on these things? Take it away Bob.

Bob French 10:53
Not good. It's not good. But, you know, and we can come at this any any number of ways, you know, there's been a lot of academic papers, looking at this, you know, we can look at case studies, we can look at just the raw raw data in and of itself. But, you know, however you cut this apart, you know, active managers don't seem to be adding value. You know, in taking a look at this, I mentioned, the academic papers, this has been kind of one of those staple papers that, you know, every cow every year, every couple years, there's a new one coming, kind of coming out with, you know, some new piece of analysis, basically, placing the data in a slightly different way, saying, Yeah, macro management doesn't work. You know.

Alex Murguia 11:44
It's, it's funny, when I, when I got into the industry, this is Oh, one right. And so this is already known information. But among advisors, you know, it's in the institutions, it's in the academic papers, but advisors, at least back then it was more of a licensing kind of profession, as opposed to, you know, you get you get a degree for which it's like that now, right. And so there wasn't, I don't think there was a lot, a lot of awareness, at least across the most common denominator, advisors, if you will about this. And you know, when you start looking at the general financial planning, and stuff like that, like the articles that were getting published, were, hey, at the failure of active management, these kinds of things were coming up, it's almost to the point now that I would say, if you were to do a dissertation, if you were to, you know, do a little dissertation proposal, or if we were to write a paper and submitted to the Journal of Financial Planning, if you will, showing how paid last 10 years active managers didn't beat an index, no one would, that wouldn't be published, because it's, it's like saying that it rains and you get wet kind of thing. And a dissertation professor would say, No, that, you know, you got to do something new, you got to contribute something new to the literature, this has been, you know, this has been done too many times. And the other piece, I would say, in terms of how this goes over and over, when I got into this, I used to, you know, I would do client presentations, and I would update these numbers on a monthly basis. And then after a while, you're like, oh, no, a quarterly is good enough, because it's towards the same. And then after a lot, you know, yearly is fine, because it's still the same. And you do it just because folks are listening to it for the first time. So they want to know, okay, but what about now, you know, that kind of thing. But it's just such a reoccurring theme over and over and over, that even in preparation for this podcast. You know, Bob, and I were talking about, hey, shall we get updated numbers, and we look at each other, and we're like, we can, but it's the same thing over and over again, in terms of the outcome. And there's, there's reasons for that, that we'll get into? Yeah. You know, but as you start looking at this, you know, there's been a number of my father's actually written one, he's found that, you know, was it through '08, I think it was, you know, active managers, basically subtracted two thirds of a percent, you know, from their investors total returns per year. But, you know, one of the things that you find when you start running the numbers is that, you know, basically active

managers get the returns, they're supposed to, based on the risk that they take within their portfolio, they're not adding alpha, their returns are very, very well explained by the risks overall, absent the costs. I think this is a very good point. Because one of the misconceptions and it's very easy to see this, then this will be our, you know, start of our CNBC reference. You get somebody speaking right, and they'll put in this this person has been in the SMP for the last five years. They're like, Oh, wow, okay, this guy, this guy or woman knows knows what they're talking about. Let me listen. And, and Bob's dad, Ken French, when he pointed out, it's not just beating the index, but it's beating the index, or beating a combination of indices, if you were relative to the risks you took, that's what's important relative to the risk you took, because you can structure a portfolio in which you're passively capturing those risk anyways, there's no like, advisor alpha, and we're going to use advisor alpha, as or investor alpha as a term to indicate that they can provide above average market returns, right. But that phrase relative to the risk you're taking, is super, super important. And that gets just obliterated when you're when when when you know, when the newspapers or writing articles or whatnot, it's bad enough that people usually don't beat the s&p. But when the if they do, when you take into account the amount of risk they took, it's it's very sub sub optimal, on a on a variety of levels. And that's kind of a level setting theme that you kind of want to put out there. We can agree with that Bob.

Bob French 16:07
if we're just looking at it in terms of raw numbers, you know, the past decade, anyone who's been a growth investor, has looked like a genius, because growth has done in phenomenally well, up until relatively recently. But if you break it down and look at it relative to the risks, what they're actually putting in their portfolio, they get kind of what you would expect, because they're a growth portfolio. It's as simple as basically effective benchmarking.

Alex Murguia 16:43
Yeah, and what Bob is saying is, okay, you're a growth portfolio, you have growth stocks, right? Well, you don't compare yourself to the s&p, the s&p doesn't, doesn't present itself as having those growth, the risk, you compare yourself to the s&p 500 growth index, or something like that, where they're, they're, they're doing it across that stable, I wouldn't be the s&p 500 growth, it would just be the SP growth index, you know, what, uh, and so those are similar risks. I mean, I remember in the.com, boom, I mean, a top 10. It was, it was like, in the top percentiles, I don't remember his top my head, but the QQQ's, which was effectively the NASDAQ index, if you were invested in the NASDAQ index, as opposed to I'm gonna buy Cisco, I'm gonna buy Dell, I'm gonna buy. At that time, Sun Microsystems, I'm gonna buy Microsoft, I'm gonna buy, you know, those kind of things. If you would have just bought the index, the QQQ's, you would have outperformed, it's like something like 90 plus percent of everyone else. So think about that. It's not just outperforming, it's outperforming relative to the risk you took. And those risks manifest themselves across different benchmarks, slash or indices. And that's important because you can passively capture that. You don't need some sort of newly minted MBA to do that. No, you don't. Right, you are some retread kind of thing. It's just you can, you know, really, sorry Wade go ahead.

Wade Pfau 18:14
I mean, the benchmarking part is important too, because it's not always just the risk. But if international outperforms US markets for an extended period. Anyone who's running a fund that may benchmark to

the s&p 500, but is allowed to allocate internationally as well has a pretty good chance of outperforming the s&p 500. And then by those sorts of metrics ends up looking like they're a superior investor, when it was really just a matter of, they're allocating to an asset class that was outperforming dreams.

Bob French 18:45
And, you know, that brings up another issue as well the wall style drift or just style allocation. You know, when you're building a portfolio, you're generally looking for funds that will fulfill specific mandates. You know, if I'm looking for a US large cap fund, if I'm looking for something to track the s&p 500, but it can go out and buy, you know, other non US large cap companies. It's no longer doing what I wanted in my portfolio to be doing. Let's take a moment to let the audience know that this show is sponsored by retirement researcher. You can learn more about retirement researcher at retirement researcher.com And subscribe to our newsletter, where You'll receive weekly actionable information for your retirement planning benefit. Retirement researcher is an online community devoted to helping you create the retirement income plan geared towards your goals.

Alex Murguia 19:43
Yeah, and there's there's even one before we even get into the really rolling up the sleeves but there's one thing I don't know how you folks feel about this, but Bob and wait but I'll give I'll give in on this count. Is there some special unique individual that's like 10 standard deviations away and was born to be an investor could that possibly exist? Yeah. I'm willing to say Yeah, sure. Even though we went over the fundamental stuff, even though we went over the technical stuff, even though we went over the market timing, maybe somebody was touched by God, you know, and there you go. But I say that in the sense of Shakespeare, Mozart, you know, Michael Jordan, you know, maybe it's Jim Simons over at Renaissance technologies, maybe he's the one. But the point is, these are once in multiple generation type of clients. You know, this isn't like some guy read one up on Wall Street. And, you know, whatever went to Princeton, got his doctorate in economics. And off he goes, those, aren't it? These are these just unique, unique, unique individuals. Those guys aren't listening to this podcast. Those people aren't, aren't listening to anyone, frankly. They're just, you know, doing it. Bob, Would you concur with that statement?

Bob French 21:11
At least one person like that. I'm not particular recently, but we have seen someone like, I mean, we have seen Peter Lynch, you know, back in the 80s, he is undeniably someone who is either so far and above the luckiest person to have ever existed, if all of his stuff was by all of his outperformance was, by random chance, or he could legitimately do it. And, you know, be observed to be doing it relatively quickly, which is also a really, really important point doesn't matter if you can identify them after the fact. You need to be able to identify them, while you can still get in and have them continued investments.

Alex Murguia 22:06
But what you mean by that, though, it just because to determine if someone's outperforming by Skill versus chance you need a long sample size, are really able to, you know, determine the signal you need, you know, yeah, exactly for, you know, for you to determine the signal from the noise and what

Bob's getting at, but when that time does come along, he's probably retiring, or she's probably retiring, because, yeah, they just don't need the aggravation.

Bob French 22:32
The The interesting thing here, though, is Peter Lynch, I, you know, I wrote an article on him a few years back now, and I forget exactly how long it takes to identify that he was truly outperforming. But it was on the order of like, three or four years into his career after he took over his fund the Magellan Fund. So it was very quick to identify. That's good. He was adding like close to a percent of alpha per month type of numbers. So he could do it. But the interesting thing about Peter Lynch, is that when he went to retire, he was able to quite obviously pick his successor pick who was going to take over the Magellan Fund. So if you think about it, he had effectively the same problem as your eye. If we were to go out and try and pick an active manager trying to pick someone to beat the market. The difference is Peter Lynch, he had access to effectively any piece of information that he could possibly want about someone, you know, there's a decent chance they were working for him. So you can observe, hey, does this guy come in early? Does he leave late? Was the was the 80s? Well, I guess it was the early 90s. So it was still key, unfortunately, you know, does this person, you know, how do they make their decisions? You know, what are the decisions that they have made? How did they work out? What are the decisions, they decided to hold back on? What are the stocks they didn't? Like? How did that happen? What are they like running a team? You know, what's their home life? Like? Are they about to get divorced, you know, are their kids doing poorly in school is are they gonna get distracted all of these pieces of information. And, you know, he took all this in, he was clearly like I said, someone who knows how to do this. So theoretically, you probably would be able to pick someone better than URI. And while the first person he picked only lasts about two years before he left, but you know, presumably he was very involved in picking that second person as well. And those two people were average. You know, and then for Back to measure, that's actually not a bad thing. You know, they didn't subtract any value, when you look at their risk adjusted returns, none of they basically got what they should. So if Peter Lynch can't do it, if Peter Lynch who, again, is probably one of if not the best investors ever can't figure out who else can beat the markets. It's a pretty tough order for us.

Alex Murguia 25:31
No, and to bring in another field, because this is what I mean, but you're talking about generational talent, if there was such a thing, right? Look, and Bill Russell, you know, arguably one of the best top three, whatever, you know, basketball player ever, you know, they won while he was coaching the Celtics player coach, but when he was no longer playing, goes to the Supersonics, I believe, and then also the kings. He could pick whatever he wants, right, nothing. Michael Jordan, you know, terrible GM, that kind of thing. And that's when you have access to you know, hey, I'm going to Delphi the traits that I add, and I'm gonna, you know, identify who else similarly has that, you know, if Michael Jordan wrote a book, hey, how to play basketball, and I gave it to my son, well, now I'm too smart. Let's say Bob gives it to his son, right? Now, you know, he's got a chance. Bob has, Bob understands that this will have no effect on your son's ability to all of a sudden flip a switch and play basketball or your daughter's ability to all of a sudden flip a switch and play basketball. You don't want to think that, right? But for some reason, Peter Lynch writes a book and you know what, let's open that account. I'm ready. It's just you have to give it its respect. And, you know, you don't you don't see that you just don't see the numbers over and over again.

Bob French 26:58
Yeah. It's, it's, it's very clear from the data that, you know, there are people out there who can beat the market very, very occasionally, they exist. You know, and I'm even willing to believe that it's more prevalent in the private markets, like hedge funds or private equity. Problem is, we have no way of observing that. And even if we could, it probably wouldn't want our money. You know, for people like that. People who clearly can add some value. Getting access to money is not the problem. You know, it's the investment ideas, you know, so in the, you know, hedge fund space, or the VC space, or any of those types of places. You know, there are VCs who are better than other VCs there are, if you're a startup company, there are certain venture capitalists, that you actively would prefer to be working with. Those people are the ones who aren't accepting new investors.

Alex Murguia 28:07
Yeah, you have to, and we'll, we'll talk about general numbers, but I think everyone, everyone has probably listened to this understands, most active managers underperform the benchmark, and we can go over return, but you know it, we'll get to it in a second. But Bob's point is very important, he would the phrase that he's pointing out is the economies of rent, go to the scarce resource? Wade, how do you like that I wasn't even an economics guy at all, you know, the economies of rent go to the scarce resources, which is like the extra returns don't go to something that's available, they go to the unique talent. And so if I am, you know, I'm somebody that can find, above average market returns consistently, I'm not going to do it in a long only mutual fund, that's a little bit of a hedge fund, right? But I'm not gonna charge if I know that I can outperform 2% a year, the market, whatever that number is, I'm not going to charge you 50 bibs, 50 basis points, or half a percent a year. Because then all of a sudden, my acumen and being able to determine stocks and what's going to happen, for whatever reason, I don't use that same mindset in my expenses of my business. If I know I can outperform by 2% I'm going to charge you 1.99 Effectively, because I am going to take those economies of rent for myself. I am going to take that extra, you know, surplus for myself. Why? Because I can't. That would be the thinking of such a person. And that's very, very important. Somebody that can outperform 10% the market by 10% a year it's not going to charge you 1% But I charge you 9.99 10% You know, whatever that number is. And so when you add that VIG Good luck. No, I mean, that's what that's what Bob was getting at by that the economies of rent go to the scarce resource, they don't all of a sudden become magnificent and want to give it to you. Wade, did you see what I did there? That was a what?

Wade Pfau 30:22
CSAT?

Alex Murguia 30:24
Yeah, word of the week

Bob French 30:26
there is one other interesting aspect in there as well. And that public versus private market divide in the public market, we have effectively near perfect information in the private market, we very emphatically do not have that level of information. So it's probably easier to beat the market, whatever market means in that context. In the private markets, you know, there are like I said, there are some people who are

just legitimately better, for whatever reason, in that space is just much, much more difficult to identify those people.

Alex Murguia 31:12
And, Bob, I'd rather if you don't mind, I'm gonna call an audible here. And this could be another podcast in and of itself, because here we're talking about mutual funds and stocks, and I even got into it. But there are a lot of factors at play in determining returns within hedge funds, and private equity. And while we're willing to say, yeah, there could be some sort of polymath out there, I'm not willing to say that the smart money really invest, and you can outperform, because there's a lot of issues involved with just pricing, transparency, etc, etc, etc, that you'll find that you don't really do all that better. But that's, that's for another time here. Let's just see, you know,

Bob French 31:52
we were drunk, or at least I was driving.

Alex Murguia 31:56
I can, we can do that. But let's just hold back on that right now. You know, I

Bob French 32:00
think a good place to start here was, you know, we've been talking about this. We've known active managers underperform for an incredibly long period of time. To the point that, you know, Bill Sharpe back in 66, this was one of his first kind of big findings, you know, he did a survey of manager performance, and they were all active managers back at that point in time, but he did a survey of manager performance. And, you know, he found that managers underperform the market as a whole, you know, if you were to just go out and invest in the market, you would have done better than, I don't know, the percentage, but the vast majority of investment managers did at that point in time. You know, we've known that since effectively the birth of modern finance back in the 60s. And, you know, as we've said, that's that finding has kind of been one of the staples of academic research since that point.

Wade Pfau 33:10
And but can you make the distinction there about between grossa fees and Netta fees like so the average active manager, gross of fees, about half of them do better than the market half do worse, but when you add in the fee drag to that, that's when you start to see that most is in with whatever that most means. 70, 80, 90% of the active managers are not outperforming the benchmark or the overall index.

Alex Murguia 33:39
And Wade, why if I were to respond to you, yeah, but that study was done in the 60s. We're in a stock pickers market now. Right, Wade, it's a stock pickers market? Now, that kind of thing. Why? And I'm referring to the arithmetic of of active management. Why is there kind of no need theoretically, to redo the study every year? Why did I get tired of viewing this every month? Because the results didn't really change? What Why would that be?

Wade Pfau 34:12

Well, you like if you look at the aggregate, not everyone can outperform the market. There's there's two sides of every transaction. So the the person who wins in the transaction, there's a opposite person that lost in the transaction. So you can't have grocer fees not including any fees, you can't have more than half of people outperforming the market Netta fees. That's where not a whole lot of people find the market for the end.

Bob French 34:39
Yeah, no, once you once you get Netta fees, it starts dropping down a lot further than half of people underperforming just almost not even almost beat just mathematically. You know, another way of phrasing that is if you think of the market as a whole, there's really two sets of investors. There's active investors There's passive investors. And at least to a first order approximation, passive investors are going to look like the market. Which means that group of active investors also has to look like the market. And the market can't beat itself. The market is going to look like the market just definitionally. So active managers as a whole can't beat the market now.

Alex Murguia 35:31
Okay, so then the question I have is, alright, but half can, and it's not really half, it's like maybe 30%, or something like that. And any given time period, right, half, you know, but let's just say for argument's sake, half can the fact I'm saying half can, is like, you should start thinking coin flip at this point. All right, and remember what we were talking about in terms of an orthopedic performing an operation, hey, half of these procedures are going to work half long. At that point, you're not doing it, you're really not doing it. So think about how our thinking to some extent, in some areas of our lives, we have this the sort of hurdles we need to cross, which is it has to kind of work more than chance, but investment, we kind of have this suspension of reality, it's kind of like you're watching the Avengers. And, you know, you're like, Okay, there's a spaceship flying and an alien came in, and you just go with it, right? But in reality, you know, that's not plausible. For whatever reason, we don't like, flip that on. When we look at investments, we want to believe in the dream, if you will. But that being the case, okay, Bob, put me in the, let's say, 70%, outperform 30% outperform? Give me the 30% absent of the previous five minutes in which you said we can't identify the best one, etc, etc. But you know, somebody says, Okay, I want thirty percent.

Bob French 36:55
no one invests with someone they think is the average active investor, you know, you're gonna go out and pick the good one, you know, she's really, really good at this. So I'm going to invest with her, he's really, really bad. So I'm not going to do that, you don't just pick a random investor, you don't just pick a random five, you pick, the one you think is going to beat the market. Now, one of the big things that I think is really important to look at are things called persistent studies. So these are our studies where they identify, you know, in an initial period, here are the stocks that want, you know, here are the, you know, in each asset class, and each category, here's the top 25 stocks, or 25%, of funds in this category. And then over the next period, in the subsequent period, how did they do? How many of them were still in that top quartile of funds in their category, how many of them still beat their benchmark, whatever kind of category you're looking at. And, you know, see if there's real skill, you know, if there's real skill here, you would expect that winners would repeat that if you beat the market in one period, you would at least have a better than average chance of doing it again, not everyone, sometimes even

in when there is skill, sometimes you'll just get lucky. You know, in basketball, sometimes you will just get a hot hand every once in a while, and they have a really, really great season, and then they come back down. But overall, you would expect this group of people who one would win on average, again, that's not what we see in the data, you know, using that, you know, top quartile in equity funds. You know, if we're looking at, you know, five year windows, you know, the, so if we're gonna say we want our subsequent period, I'm looking at data that ends in 2021. So our subsequent period is 2017 to 2021, the initial period would be 2016. Through I believe it's 2011. So 2011 through 2016, those funds that were in the top quartile in the top 25% of their category, they had on average, a 24% chance of being in the top quartile again, being in that top 25%. Again,

Alex Murguia 39:38
which, which actually makes

Bob French 39:41
sense, that will just literally exactly make sense.

Alex Murguia 39:46
Well, yeah, maybe I'm off by 1% is gone, which,

Wade Pfau 39:51
if it was completely random, you would expect 25%

Bob French 39:55
Exactly, yeah.

Wade Pfau 39:56
Group to be in that top quartile again.

Alex Murguia 40:00
So, so So this is kind of what's happening here. It just to say, without the numbers this year, we're looking at people that performed over five year periods, and they were the top in the top 25%, then we look at them in the subsequent five year period. And you could do this going back to 1970s. And it's the same thing. And then when you look at it in subsequent five year periods, what happened, and they consistently regressed back towards the mean. And so there's a lot of reasons for that. And you know, some funds could just go out of business, too. That's why maybe it's a little less than 25%. But there's a lot of reasons for this. So another way to think about this, really is, there are their 8000 mutual funds, right? And so you put them in a stadium, you ask them to flip a coin. If it says you stay in the stadium, if it's tails you get out of the stadium, doesn't quite work like this. But let's say after the first year after one flip, the 1000 goes to 4000. Then the second time it goes to 2000, then 1000, then 500, then 250. Okay, so you started with 1000 after five flips, not going to work exactly like this. But after five flips, you're at 250. That's what you would expect, right? 50% chance, boom, boom, boom.

Wade Pfau 41:15

And on this example, to be clear, they're they're predicting the coin flip. So now at this point, yeah, it's 150 people who think you have some sort of skill at guessing with that coin flip.

Alex Murguia 41:24
Yeah, thank you. So no one here looks at those people. No one listening to this looks at those 250 people and think those are great coin flippers. Oh, my goodness, no one thinks if you put those coin flippers back in the group of 8000. And repeat this 5000 Repeat this thing five more times, that those 250 people are going to be the same once, after five more times. That's the pattern that you see here. But for whatever reason, when it comes to investing, you know, think about it, CNBC, right? I don't know how many, it's 200 and something workdays in the year, right, you can put one of these coin flippers on every day, you can put one of them on every day. And as a person watching, you're gonna think, wow, there must be skills because look at this guy, you know, they they're finding them, like pretty handily, every day, I'm seeing one guy, that's one person that's been in the market or that over the last five years. So I'm going to listen to this person. And that person is going to give you some chance. It's not the fact that there's 250 People that gets me is that there should be more of their skill. That's the thing, there should be more than 250 as actuals go, and you listen to them, and they give their reasons. And you're like, Oh, well, okay, well, five years, performance EQ, that's pretty good. You know, you know, sunlights burning, you got to decide at a certain point, right? But here's another example that you would never listen to this person. If, if, if two hun if 8000. People decide 90,000, let's just say if 100 people decide to jump off a three story balcony. It's fair to say not all of them will die. No, no, it's follow me. There'll be there'll be some group that lives maybe they landed on somebody that felt first or whatever. But they're not all gonna die, maybe they'll break their feet or whatever they want all died, some will survive, right? Just by chance, you're not going to, you're not going to look at the person that live and think I'm going to jump out of a building the way this person did. Because look, he lived or he lived. You get the job that this is just pure chance. But we don't make that connection for whatever reason. When it comes to this kind of performance style, you know that those 250 people write books, and all of a sudden, oh, well, it worked for them. And you know, I'm gonna do this and implement, it just doesn't work. That's what the persistence studies teach me that, if there was this ability, they would continue, they just don't, and they do so less than we would be predicted by champion,

Bob French 43:56
You know, in fact, one of the best predictors, if someone's gonna stick around in that top quartile is cost. Because one of the really interesting things you find is that, you know, we were talking about numbers on the stock side on the equity side, if you look at the bond side, well, that that average goes all the way up to like 30% of this, the initial winners, one in the subsequent period. And when you start breaking it down, it's because the in on the fixed income side cost is so much more important. You know, the ones who want initially tend to have slightly lower costs, meaning that it's a cost or it's not that these guys were able to predict the bond market better than stock managers were able to predict the stock market is because they had a lower cost barrier. And it really just like everything else in investing, there are certain things that you can control and cost is one of the few actual observed Trouble, concrete things. So once you can control for that, all of this story goes away. So that's kind of one of the big things. And you know, being able to tell those stories consistently. Really kind of, as Alex was talking about really kind of cements in a lot of people's heads. How it should be easy to do this, you know, they're on CNBC, there's a new one every day, which means it's all over the place. So I can

do it too. Are you getting close to? Or are you in retirement? Well, investing during retirement is a little bit different than during your working years. Your investments are there to help you pay for retirement. And now is when they need to earn their keep to make sure you're on the right track, download Retirement Researchers eight tips to becoming a retirement income investor by heading over to retirement researcher.comeighttips, again, get retirement researchers eight tips becoming a retirement income investor by going to retirementresearcher.com/eighttips. That's the number eight tips.

Alex Murguia 46:15
Yeah, and but you're this is where you know, there's a bit of a psych piece that comes into lists. And not I'll give you the example. And then I can say the name but everyone understands smoking has had that hazardous to your health. Right. And every once in a while somebody in your social circle will smoke and somebody will say, hey, not that they don't know this. But as a sign of concern. You say, hey, look, this is gonna kill you. This is, you know, you're putting your life in your hands. And sometimes at least maybe not now, but even 10 years ago, there was it Yeah, but my uncle smoked until he was 90, and he died of something else. So I'm good. Now, that kind of thing. You're using the exception the survivor, as the rule, right. And that's effectively survivorship bias, you're forgetting all the ones that are that did not survive. Now, if all of a sudden if you use all those coin flippers that had to leave the stadium, you realize, you know what odds are, I'm going to be like the 7750 people that had to leave that lost this game, not the 250 people that were lucky to win this game. You remember the winners, not the losers, which is the survivorship bias, you remember? Oh, but you know, my neighbor across the street got this 10 bagger. And look at that, trust me, for every one of those. There's 100 of the inverse story. They just don't they just don't like advertise it. You know, and as much as your neighbor may have gotten a 10 bagger, he probably has, you know, a couple of of investments were lost sure he or she lost? Sure. It just don't advertise it. And so you remember the winners and you forget the losers quite often. And that that, you know, the winners become more impactful, because it's just a better store.

Bob French 47:56
And you know, not only do you have to worry about you know, whether these managers have the skill to deliver on this type of stuff, they're they're trying to deliver it trying to deliver on that outperformance you have to start wondering and worrying about how they're trying to do that. So one of the big things that people are looking at, when they're evaluating manager performance is their performance relative to their stated benchmark. You know, as a manager, you can go out and say, I'm running this fund, you should benchmark me against the Russell 2000, small cap manager, benchmark me against the Russell 2000, or, you know, I'm a US equity manager, benchmark me against the s&p 500, whatever you want to do, you got to worry about that miss specifying that benchmark, you got to worry about them kind of defining their investment objectives incorrectly for the amount of risk that they're taking. And we already touched on this a little bit earlier on, you also got to worry about them changing through time, with style drift. You know, I don't think we've talked about that this month or all that much. But, you know, that's this idea that, you know, through tie, you know, the fund will change, the fund will not be in that same category, or delivering the same risk experience that you were looking for it initially.

Alex Murguia 49:21
I'm a little cynical to this as well. And there have been studies where you see, again, returns usually comp not usually, I mean, you can almost like bet on it, but it comes relative to the risk that you're

taking. And so some of that is random when those risks manifest themselves when those returns happen to manifest themselves. But if you have enough funds out there, some will have timed it right? If not for just serendipitously, time to write. And so if all of a sudden, small caps hit mid caps just go crazy, right? And I'm classified as a s&p 500. Manager. I am going to look like Peter Lynch. Right. And my assets go for I don't know, whatever, 50 million to 5 billion to 50 billion, whatever, some insane number, at that point five years in. The dirty little secret is if you don't blow up that portfolio, people are not going to leave you like Captain woods with the Ark fund, if she would have kind of switched her positions, and just follow the NASDAQ Yeah. Her attrition rate for investors would not have been what it is now and an order of magnitude. And so what they do you know, they these folks are making a living, it's a business. And so once they kind of hit it big and a lot of these mutual fund companies put out like 12, feeder funds, 120 feeder funds, just to kind of see which one hits by luck. They close the you know, which ones hit, let's say five of those hit great. The 15 That did it, they just shut them down. Right, and they keep those five, those five start aggregating assets, because they're they get these Morningstar stars, right. And all of a sudden, five years in, they're managing an insane amount of money. They're in 401k plans, they just start tracking the index. Why? Because the returns will be fine. No one's gonna be like, Oh, my goodness, you know, something seismic happened here? No. You, you're that you had that insight based?

Bob French 51:28
No, it's entirely accurate. I mean, they and you're absolutely right about those feeder funds, they'll basically create 100 funds, 100 value, exaggeration, but 20 funds, you know, at any given time, you know, feed them with a couple 100 million, and let them run. And then after three years, when they've got that three year track record, they'll kill the ones that don't whip, you know, once they you know, get to that point where people will say, Oh, they've got a track record down and start feeding money in outside investors. There's a saying in personal finance, you know, once you have it made, don't risk it. That very much applies to active managers, as well, you know, once you have it made, once you have a good track record, and people are going to be putting money in, don't risk. And people will only pull money out once you generally, once you start losing to the benchmark. So don't lose the benchmark, just get the benchmark by and you end up with a really, really expensive index fund at that point. So, you know, that's absolutely one, that kind of third thing you want to be thinking about, with regards to you know, how active managers are putting these portfolios together. But Alex, you had another point that I think is really, really important to think about as well, you know, let's say you do have that small cap fund, let's say you are, you know, that small cap manager who has had, by one way or the other, you've had a really good five year period, and now you're on everyone's Morningstar screens, and everyone wants to start putting money into your fund. That's awesome for you. But think about it from even assuming that you actually have skill. You're the next Peter Lynch in the small cap space? How much of that can you actually put to work? You know, you start getting a, you're a small cap fund, you've now got $5 billion, under as under investment, you've got $5 billion, you need to invest? Is there $5 billion of investment space in the small cap companies that you think are good? Probably not. So you've got a choice. You can either, you know, start investing in companies that you don't think are as good, that are not as good investment opportunities, which again, you know, just means you're getting closer and closer that closet indexer. Or you can start investing outside of your mandate, you can start investing in bigger companies who you think are pretty good, you can start investing in a non US companies, whatever it might happen to be, but not what people hired you to manage for. So you can

either become a closet index, or by just investing in stuff that isn't quite as good. Or you can start having some pretty substantial style drift, you can start investing in stuff that your investors aren't asking you to expose them to. So, you know, this is one of those position polls, you know, as the manager gets more and more successful, or at least they've gathered more and more assets, which for the manager that success, because that's how they make their money. You know, almost invariably, that's gonna lead to the fund not doing what got it to that point.

Alex Murguia 55:11
But just because this is I mean, I don't know, I think it's a comfortable conversation. And we could probably do another hour on this because this is one of our real hobbyhorse here. But I'd like to maybe my parting thought here is this as much as we're talking about the failure of active management. And this is regardless if they're doing tactical or if they're doing market timing, or they're doing fundamental. In God, we trust everyone else bring data, what do you find? below, below suboptimal performance? The other comment that kind of is, it's just stupid. When people say this, they know better at this point, they know better. They're just, to me again, this is just they know better and that they shouldn't be saying this. If you invest in index, you just get average returns. It's almost unamerican of you to do that, you know, what the heck are you thinking? And okay, not really, you don't get average returns. Because the reality is, over the long term, what happens is, again, if these many people underperform in one year period, over a three year period, the probabilities go up that donor performer or a five year period of hobbies go up that you're going to underperform. So if you actually are an investor, that's just capturing market returns, I'm not saying this stock is going to be better than that stock or any of that I'm just capturing them all. I'm like harvesting returns like a farmer in the field, I don't say this corn stock is going to be taller than this corn stock is going to produce more grain than this one across millions of corn stocks, I just going to harvest the whole thing, right. And that's what I'm going to capture. So if you do that, from an investing standpoint, over a five year period, you're actually going to outperform the majority of active managers not by a little bit by a lot, I'm hesitant to say 80% 70% 85%. Because I just don't know that top my head. But yeah, it's in that range. Yeah, it's a vast majority of it. And so it's for the when you hear the I don't want just average returns. Just just, I'm trying to keep this as a PG. Podcast, Wade, because I know, that's your sensitivity. But it's it's not true. And these people know this at this point. And if they, at best, at worst, they know this, at best, they're just dumb, you know, you want to be bad, but bad person or you want to be at a complete idiot. You know, when you make statements like that? No, I don't know, it is what it is, man. So that's my response to that Wade, Bob, am I wrong?

Bob French 57:39
No. In fact, you know, your, your choice of words there that its indexing is is unAmerican. I don't know if your that was intentional or not. But that was literally one of the big things people would say when indexing was just starting to come out that it was unAmerican, not to try and be the best. And, you know, indexing, I mean, emphatically is not trying to be the best at any given it's not trying to pick the best stock. It's not trying to be the absolute winner in any particular year. It's just that consistent level of don't find the ends up winning.

Alex Murguia 58:24

UnAmerican this goes back to my comment in the last podcast, we batch these podcasts, I don't know if it was like, so I'm going to stop the game where I say a week ago or a day ago, you know, because I can't keep up. But it's actually totally American. Because a 32nd pitch. If you're indexing, you're saying capital markets allocate capital efficiently. That's as American as it can get, you know, and the only folks that think they're not allocated efficiently and they can like engineer it by selecting prices that are off or whatever, or the communist, right? No, I mean, at the end of the day, are people that want to suit white people that want to engineer society? No, I know how capital should be allocated. And I'm going to try to you know do so and force it because back to the price takers price enter as you know, that type of stuff in the lab podcast. So it's a no it's actually as American as apple apple pie. So I'll end with that Wade, however you want to, you know, what are your parting thoughts you had for myself? You heard from Bob?

Wade Pfau 59:31
Baseball and hotdogs as well, but no, that's right. It's if you believe in capitalism, really, that's what an index fund is doing. Otherwise, you're a central planner who thinks one individual can better

Bob French 59:44
I was pretty trident about this one. I didn't ever come to the point that asset managers are communists but

Alex Murguia 59:55
hey man, my my parents I'm not going back. I'm done. So no, I mean, I don't know that as well as you guys do the philosophy behind it, but at the 40,000 feet level makes all the sense in the world. All right, and that's that's a wrap guys.

Wade Pfau 1:00:27
Thank you for listening. And we will have to figure out what next week's episode is going to be about. We can't say join us next time for such and such but I think we are planning to bring in some additional outside folks who can

Bob French 1:00:41
Yeah, next week should be a really really great one. There's some some fun stuff coming up. Taking a look at you know, how the financial media kind of plays into all of this and really kind of diving into that and really taking a good look there. There's some there's some interesting stuff.

Alex Murguia 1:01:02
Hey, Bob, did you ever write cliffhangers for like soap operas and stuff like that? Because Because I mean, I think you should because what did he say? Let's come back next week to learn there's some interesting stuff. See, I can't wait. I can't

Bob French 1:01:20
I know I work here so

Alex Murguia 1:01:28

we'll see you next week. Thanks for you. To catch waves a little like insurance when he is there awesome. All right, everyone, bye

Bob French 1:01:43
Wade and Alex are both principals in McLean Asset Management and Retirement Researcher. Both are SEC registered investment advisors located in Tyson's Virginia. The opinions expressed in this program are for general informational and educational purposes only and are not intended to provide specific advice or recommendations for any individual or on any specific securities. To determine which investments may be appropriate for you, consult your financial advisor. All investing comes with risk including risk of loss. Past performance does not guarantee future results.