

“Confirmation bias is when we look at data that most agrees with our current outlook.”

Paul Adams: Welcome to Your Business, Your Wealth. I'm Paul Adams. I am the founder and CEO of Sound Financial Group, and I as always, I'm just absolutely ecstatic to be talking to all of you today. And with my friend and partner, Cory Shepherd here with us today as always making sure that I'm well supervised. Last time he left me alone, I changed the name of the podcast. So Cory...

Cory Shepherd: That is... I'm still not sure when my next vacation is gonna be, but I am also happy as always to be here, Paul and I don't get to hang out as much now that I'm in Chicago. So this is like our weekly hang out time.

Paul Adams: Indeed, indeed, we get to spend it with all of you as well. Today, we're covering down on this idea of the way that people try to beat the market. But we don't think about what it takes to outperform the market or what everybody else is trying to do to outperform the market even though there's zero academic evidence that it works. As a quick reminder I want all of you to take a minute, like if you're watching this on YouTube, hit subscribe, hit that notification bell, hit the like button. If you're listening on a podcast, you really wanna help us out, you wanna help this get in the hands of other people, you can always post or share on social media, all of the podcast analytics care a lot about that back-linking, but if nothing else, if you haven't written a review, give us an honest rating, give us a review, and if you take a screenshot of it, and send it in to us, we'll send you a couple of good books to help you with your financial knowledge.

Cory Shepherd: Oh, and another reminder/announcement, we have an upcoming second appearance from Jake DeKinder of Dimensional Fund Advisors. Having him back on the podcast, which is not common for them to do this kind of media and this kind of... These kind of interviews. So today's episode is kind of a refresh and run up on some market-based topics to get you all ready for Jake. And the reason why we're doing it is we wanna have some fun with this, and give you a chance to email us with any questions you'd love to hear us ask him about the world of investing. So if you're hearing this podcast, I would send us those questions within the next two or three days to make sure that we can get it in and get it on our agenda. So, that's info@sfgwa.com, we would love to include some questions from the audience there for Jake.

Cory Shepherd: Now, this week in planning at Sound Financial Group, I have a great article; I seized it from Kiplinger, so you can find it online. We'll have links to the show notes and the title of this article is, "Is a stock market correction in the cards?"

Paul Adams: For those of you who are watching this on YouTube, you're gonna see the actual article itself, and we've got our producer in studio here, Jordan Fenster, he is doing a great job cutting us back and forth. So if you can't see this right now please send all the complaints directly to Cory about Jordan. [chuckle] Okay, here's what the author is talking about. He is like many articles they want to say what we talked before about the amygdala hijack, the fact that they want you to see things as an opportunity that has

“In a ten year period, it’s not uncommon for just ten single days, about a day’s worth per year, to be worth almost half the rate of return for that whole ten years just by themselves. The best ten trading days can often be fifty percent of your positive gain over that whole time period.”

to be jumped on right away or they want you to see it as a significant problem you better run away from right away.

Paul Adams: And this is no different. He starts out in the article and all through the article there's all kinds of data. So he starts out saying, "The S&P 500's been doing really well", which as we talked about before, all of these authors and news outlets tend to cherry-pick the actual index that they use, so that it's the one that creates the best point that they're trying to make. Next...

Cory Shepherd: He's even quoting Benjamin Graham in the midst of this article, which is a very solid resource for the world of investing. Like some of the most loftiest, short of quoting the Oracle of Omaha himself, it's some really good source material.

Paul Adams: Yeah, and a guy there says, "Hold discipline in the market and don't jump in and out," and yet a guy has quoted him in an article where he's implying that maybe people should move their money in and out of the market.

Cory Shepherd: Even the title is a gambling metaphor in and of itself, which by the way, the answer is yes. Any time you invest in the market for the long term, there is a correction in your future. It is coming.

Paul Adams: Indeed. So at some point it's like... And the thing is the market's gonna go up and it's gonna go down. And when it does it's just gonna be inconvenient. That is the thing that we know for sure. But if you keep going down, it talks about the economic picture is murky. It goes a little further and talks about there's some declines in housing stats, again data, data, data. He's pointing to as to why he thinks we're gonna have in the next section a reversion to the mean. So that means if we've been getting in the S&P 500 15% returns, and long term it's only yielded 10, then we should be back below the average for some period of times for the average to be the average. But then he gets to what you should do. And what you should do is basically maybe leave some more money in cash if that's what you feel like. Like this is the one section, the guy has zero actual data. It's just it depends on how you feel and depending on how you feel you could do this or you could do that.

Cory Shepherd: I mean it's so common, especially in the financial media, but all over the internet, this kind of clickbait... It's very entertaining and encourages you in, but doesn't give you a whole lot to do. And for this context, the best case is you're still speculating. It's not really even a grounded strategy. And then we also noticed, we had a lot of fun with this, if you go to the bottom of the article...

Paul Adams: I got it up now.

Cory Shepherd: Past the comment section... You got it up?

“If you look at, all the way back to 1926, the average gross return of the S&P 500 was ten percent versus three and a half percent for Treasury Bills.”

Paul Adams: Yeah.

Cory Shepherd: Paul and I are looking at different versions online, so we have different targeted ads, some with the same headline, but different pictures. There's some AB testing going on. Paul, you had a couple of favorites, I don't know if they still...

Paul Adams: I just think it's so funny. There's this very attractive, red-haired woman, young lady with a bunch of freckles on her face. Now I don't know what her sitting at the back of the car has anything to do with this. "Six credit cards you should not ignore if you have excellent credit." Don't know why.

Cory Shepherd: But is she old enough to have a credit card, does it look like?

Paul Adams: I think it's on the border. "A shockingly lucrative cash-back card, if you have excellent credit." Again, it's just like some... Not photoshop, but like, whatever you buy from the online photo galleries, a cute-looking young brunette gal holding up a card. Then we have a very serious man with a goatee, it's like, "Watch out for these critical mistakes if you're working with a financial advisor: 12 steps." And then my favorite is Harry Dent, which if you haven't had a chance to do this, I would encourage everybody as a part of this week's in-planning, go to Amazon.com, look at all of the books Harry Dent has written. In which this guy has the most brass ego I've ever seen.

Paul Adams: He has been wrong again, and again, and again, and not a little, like with 300 pages of research books and you can look at his books mis-predicting what the markets were gonna do going back like 20 plus years. And he just keeps writing another New York Times best seller about every seven years, 'cause he... I think what he does is he waits until it looks like people are in a big questioning moment, and then he offers a bunch of thinking. Even though in all likelihood, if you had followed what he had done, you would had ended up with very low returns over this period of time. Okay, so Jordan we're done with my computer screen if we're out of there.

Paul Adams: Right on. Good. Well, so let's maybe get back to our matter at hand today...

Cory Shepherd: Yeah.

Paul Adams: With all my agitation from looking at somebody who... It's like, they're predicting there's going to be a stock market downturn and then they don't even tell you when to get out or how. Like, at least, if you think there's gonna be a downturn and you think things are over...

Cory Shepherd: That would be valuable information to be able to act on.

[laughter]

“Profitable companies tend to perform better than non-profitable companies.”

Paul Adams: Yeah, just have the courage of your convictions and be like, "This is what you should do." Like it's like that last part he's like, "This is the part where I could be proven wrong. So, I'm just gonna say, if you feel like more cash, keep cash." Okay, I will get over that, probably not reference it again, though I find myself a little agitated. Sorry to everybody listening. Okay, so the thing is as you're thinking about stock market returns and as we sometimes get seduced into wanting to try to beat the market, we're gonna talk a little bit of psychology and why that happens, but second, some discipline things you can do to prevent that from happening to you.

Paul Adams: It's... We talked about in our last episode that people will try to do things, like invest in the right stock, in the right market, etcetera, but it gets them in trouble. And you think maybe I could beat the market, but the question is, what data do you actually rely on? And one of the big problems is there's two things constantly pulling at us. There are actually psychological issues, having nothing to do with data. One is confirmation bias and the other one is survivorship bias.

Paul Adams: Now, confirmation bias is when we look at data that most agrees with our current outlook. So, a simple example is, you can go to Google and do a Google search and what Google does is exactly the same thing your brain does when looking for information. So if you search "stock market crashing when" you will not get any articles about discipline strategies, making sure that you've rebalanced, not jumping out of the market, you're going to get every search result that agrees with that already existing way of thinking.

Cory Shepherd: It's like our brain... You know, it wants to give us more of what it thinks we want, just 'cause that's the survival instinct back when searching for food was all we wanted. Or searching for your car. Like the great example is, I bought a white car and I'd never had a white car before and it wasn't until I had a white car that me and my wife especially noticed how many white cars are out there, just how hard it can be to find your car out in the parking lot. Now, there are not more or less white cars than there were just a year ago, but it wasn't like my magical control, it's just my brain focusing on that. Now, survivorship bias is the other one that Paul mentioned that plays into our brains and it's only hearing from those who survive, like only hearing the sample set that supports that story already, or the person that's banging their chest saying, "I saw this coming."

Cory Shepherd: Like, avoiding the tech bubble of the early 2000s and coming out unscathed. Those who left real estate before the 2008 bubble burst. We know lots of people lost money in real estate during that time, but you don't hear that in the public story anymore. People who are into real estate now are those that said, "Oh yes, I got out at the right time, or did whatever I needed to do to avoid that bubble." And then there's also those who were in the stock market getting out before the drop in 2008. They bang their chest about how they got out, but that's not the whole story. The whole story is how many dead bodies were on the wayside to produce those few winners.

“Over a ten year period of time, these factors of return, these dimensions of return, outperform eighty-five percent of the time.”

Paul Adams: Indeed. And as you're listening today, we want you guys to think about, how can you protect yourselves from these kind of cognitive errors. And first, be careful the questions that you're asking. Now, not just in Google, although, you should probably be careful of the way you ask things of Google, but it's the question that's in your mind and in your heart about how you're absorbing the world. So for instance, as a business owner, you're gonna get very different answers if what you say to yourself is, "How do I consistently make \$800,000 of income from my business?" Versus, "How do I grow a business that has \$20 million of revenue?" Now for your industry, maybe \$20 million of revenue equals \$800,000 of income, but there's lots of ways you can get the \$20 million of revenue, and be taking home \$100,000 income a year...

Cory Shepherd: Yeah.

Paul Adams: And over-invest in the company. So it's always making sure that we're looking for the right thing, 'cause we'll find solutions to those. Same thing with people who say, "How do I avoid the next market downturn?" Well, that's probably not the question to ask. The question to ask is, "What should I be doing with my money and my finances to be in a position that I actually reach definite financial independence? Where I can get to a work optional lifestyle." Not retirement, we've talked about in the past this is not a retirement game.

Paul Adams: Most of you listening are not people that are wired to retire. But the reason you became an entrepreneur, the reason you became a business owner was why? Freedom and autonomy. Well, the greatest way to have freedom and autonomy is to also have that money built on your personal balance sheet. So ask the question, "How do I create and maintain my financial independence?" is very different than, "How do I get a higher rate of return or avoid the next stock market downturn?"

Paul Adams: When you see that somebody else like at a cocktail party or something else, they're referring to how they got out, they escaped it, they killed it, just ask kind of a fun question. Like somebody says, "I bought Apple when it was \$4 a share." Ask, "Oh my gosh, that is really great. How many shares did you get?" Now, I'm not looking to prove them wrong. What I'm looking to do is to not let them plant inappropriate thinking in my head. I just want to make sure that I hear them say it's like, "Well you know, I bought \$1000 worth of them. But now that's worth \$20000," so, that mentally for me, I can just go, "Ah, so he turned \$1000 into \$25,000, which means for me to do that I would have to do that, plus, I still have to get another \$8 million," or whatever your numbers are, "Another \$8 million to have enough capital at work to then be able to... So it doesn't make that big of a difference." So I'm insulating myself by interrogating reality just enough so that I know what actually occurred.

Cory Shepherd: And remember that person, if they're holding court at that party, might not think your question is very fun, however it could be the most beneficial thing you're

doing for yourself and everyone else listening. The stakes of their financial future on the line for not letting that seed be planted.

Paul Adams: Totally.

Cory Shepherd: So, be warned.

Paul Adams: Indeed, indeed. And I think you're doing it like super friendly, like, "Hey."

Cory Shepherd: Totally.

Paul Adams: I have been known to be called just offensive enough, not too offensive, usually. But yeah, maybe take Cory's advice about cocktail party conversation, not mine. But let's switch next to how do people attempt to beat the market usually, what are those fallacies?

Cory Shepherd: And generally, it's in two ways: The first being stock selection, just either thinking they can do it themselves through some kind of portal and dashboard and information tracking, or that indirectly an asset manager can do it for them, being in the right place at the right time in the stocks. And then the second is just overall market timing. Knowing when to get in, when to get out, and saying, "I just needed to get out of the market right before the dive in 1987 when it was down 22% in one day." So if I got out the day before that, and then got in right after it came back, then things would be perfect. But you can't just look at the calendar year returns 'cause so much happens in the interim, and over short periods of time.

Paul Adams: In fact, I've got something to share on that. So Jordan's gonna let you guys see my screen here, and I wanna just show what it looked like for the person that escaped that window. This is about September of 2008, where we had this super drastic drop in the market, the market had been up and down a little bit but it was September that we had this huge one day drop that then culminated in reaching its bottom in March of 2009. And what you'll hear every now and then there's somebody at these parties, something else going, "Yeah, we've got everything out of the market, summer of 2008. Totally missed the downturn. It never hit us, never hurt us".

Paul Adams: Now, two things that are a problem here. Number one, this chart is only looking at the Standard and Poor's 500, so yes, it dropped precipitously, and hit bottom. But what some people talked about, and you heard on the news was the idea of a lost decade which is true. If you looked at the bottom of 2009, which you can see in this chart, if you track that back 10 years, pre the tech bubble, you literally had a window of time, for about the next year and a half, two years, that 10-year back testing would have showed you zero return in the S&P 500. This is why we want an academically allocated, globally-diversified portfolio that's rebalancing at least every year, because that gives us the best opportunity to be buying these things when they're low because other assets

don't drop as much as... Some assets don't drop in value as much as others, selling those, buying the other, even in a down cycle is a really good, consistent strategy to be in.

Paul Adams: But in this case, if even if you got out, let's say the very beginning of September before the drop, you would have to go all the way back in to have benefited from the drop the most in March of 2009. Now, I remember being in study groups and I think you do too, Cory, about things like, "Banks are never lending again, we're gonna have to do all business financing through private equity. People are gonna have to go public much more quickly 'cause it's just gonna be capital markets. We may go off the dollar standard. Oil's no longer gonna be priced in dollars. We're gonna be in huge trouble." And now, none of that ultimately happened, but it was a really scary time.

Paul Adams: So if you had 5 million in assets you would have had to have come completely out and then put all the chips back in at a time when people were losing their ever-loving minds about the market. And then if you waited till things felt a little more normal, like the beginning of 2010, you literally did not avoid the market downturn at all. Because the S&P 500 had come back to pre-crash levels that quickly, like you would have maybe saved 5% in return. But you had all the anxiety and risk of maybe getting out at the wrong time and not getting back in in time. In fact, many scenarios of waiting, like two years, you would have actually been at a loss even with just the S&P 500 getting out and then attempting to get back in within 24 months. And so, again, insulating ourselves, what's the rule here? Very simple. You can ask the question, "Oh, you got all your money out, that is sweet. When did you get back in?"

[chuckle]

Paul Adams: And I think, frankly, what can happen for people when you do that is they may ask themselves the question and even be a little more straight with themselves, to say, "You know, I don't know. I think that it was like three years, four years," and to Cory's point earlier, not only helping them maybe think better about money and yourself, but anybody else that's within earshot to really just interrogate it a little bit, to find out what really happened because odds are, "Well, I took my 401k out, but it was only \$40,000." And just in the last two years, Cory and I have met several clients, who were not people that were most judicious about their money, but they were savers that had financial advisors recommend they take their money out pre-2008 and like eight, nine, 10 years later, their money is still in the cash equivalent and their 401ks. Tremendous loss of wealth.

Cory Shepherd: And you know one piece of data that can help you insulate yourself, and you may throw it out at that party if someone's pushing back to you is just this idea that in a 10-year period, where there's usually something like 5000 trading days that the market is open during that time, it's not uncommon for just 10 single days, about a day's worth per year to be worth almost half the rate of return for that whole 10 years just by

themselves.

Paul Adams: Yeah, just that's the best trading day.

Cory Shepherd: Yeah, the best 10 trading days can often be 50% of your positive gain over that whole time period. So you can say to yourself and others, "Why would I try to guess what days those are? If I'm out for any days at all, that could be losing huge amounts of return."

Paul Adams: Yup, and there's one hidden way that people try to do market timing that can look like proper asset allocation that's tactical asset allocation. What this means is the asset manager or the financial advisor is saying, "Oh we're only gonna own indexes or we're gonna be mostly passive, but we're gonna change our allocation and it's gonna be something effective." They're gonna make a bet effectively with your money about what they think China is going to do or what they think Greece is going to do or what they think some other economy or industry is going to do and then they tilt the portfolio toward those things, which is a fancy version of market timing.

Paul Adams: And there's all kinds of anecdotal evidence that they can point to in the past that they would have been right about something but here's the real problem, going all the way back to the work we've talked about in saying even just Morningstar, are they able to predict, is that even the asset managers themselves, if they have a good run are not that much more likely to have a good run the following five years, if they had a really good five years. Why? Returns are random, and it's a fallacy that these advisors have the ability to pick stocks and outperform. There's just no academic evidence we could do that. But let's take a moment, we're gonna go to commercial, hear a little bit from Sound Financial Group. When we come back, we're gonna hit on what are the four factors that can produce additional return and how can you integrate them into your life.

[music]

Cory Shepherd: At Sound Financial Group, we are committed to continuing to bring you sound financial bites. Hello, my name is Cory Shepherd, president of Sound Financial Group. If you are finding value in these weekly podcasts, and they are making a difference in the way you think about money, then think about what kind of a difference could be made if you engaged one of our advisors to help you look at your personal finances. So what would the next step be? Send an email to info@sfgwa.com with "philosophy" in the subject line. And we will coordinate with you, to have a conversation with Paul, myself or one of our other advisors to share with you our philosophy of money.

Cory Shepherd: No one is going to close you on that call, no one is going to make you an offer to become a client. The only thing we allow our advisors to do in that call is teach,

and the only thing we allow you to do is ask for an application. While we don't accept everyone who applies to work with us, we are committed that any sound financial bites listener who wants to go deeper, has the chance to expand their thinking and walk away with new education and resources around money. So even if we find out we aren't right to work together, our team will absolutely take care of you in that call, and make sure that you have access to resources that might be of help to you.

Paul Adams: Welcome back, and here's the promise. We mentioned that there are four areas where you can actually get additional return in a portfolio that are academically proven to actually get you more return. What we talk about these four areas, or four dimensions of return very simply, these are places where we get compensated risk. Everybody's heard this story about risk versus reward, and the idea if I take more risk, I get more, what Cory?

Cory Shepherd: Reward, return.

Paul Adams: Yes, but not all risk is rewarded. I use the golf metaphor a bunch. You guys have heard it on this podcast before, but if I'm hitting with a driver, I'm hitting with the driver in hopes to hit the ball further, taking on some amount of risk that I could hit a house, or land well out of balance, but there's another...

Cory Shepherd: Very high level of risk in some people's golf game...

Paul Adams: Mine especially. [chuckle] So if... But I take on additional risk but there's evidence that I could hit it further than I could, say, with a seven iron. But if I took that same golf club and said, "Well if the reward is this good for just taking the risk of hitting a golf ball, what I'm gonna do is go into a biker bar full of Hells Angels, and I'm just gonna find the biggest guy in the place and hit him with the golf club because that is way more risk and therefore more return." That is a terrible idea. Like full disclosure we should put this, don't ever hit a biker with a golf club, probably or anybody else because there is no correlated positive outcome to that particular risk-based decision.

Cory Shepherd: None.

Paul Adams: Because of that, there are hundreds of things that are out there that could be some amount of additional risk but may have reward but they don't qualify as being both persistent and profitable. Cory can you just pull that apart a bit?

Cory Shepherd: Yeah, this just blows my mind. And it's one of the parts that can make this whole investing thing so tricky 'cause there's things out there that are real, factors that you can take advantage of that academics have proven do exist and have an impact on the market, but they cost more to implement than you gain so you actually lose through winning. There's a difference between an academic ideal, and practicalities of real life. One that comes to mind is called momentum. So, a gentleman had given me a

book on momentum investing, this whole strategy, and he said, "I want you to check this out, and see what you think, 'cause I think this could be great." Now, number one, if the person who wrote the book was doing a thing that was successful beyond their wildest dreams... What?

Paul Adams: Full disclosure Cory? I hate to interrupt you but in the full disclosure, wasn't it his wife heard you on Academic and Globally Diversified and she said, "My husband's got this crazy idea that we should be trading the way this book is saying to do. Would you please read it so that then you could have a rational conversation with him about why we shouldn't do it?" [chuckle]

Cory Shepherd: Well, yes, that is... That is the situation that was happening.

Paul Adams: We're not naming any names, but I thought that that was pretty appropriate for both our spousal listeners.

Cory Shepherd: And this is not folks who are clients we're investing with. All our clients who are looking at each other saying, "Was that you?" "No I don't know." No, no, you don't know who it is. So momentum is the idea that if you watch a stock or in this case for the book really a sector of stocks start going up, that just like the car that you just push down the hill coasting, it's gonna pick up momentum and whatever direction it's going in, it's gonna keep doing that for a while. So immediately I was like, "Well okay, number one, if this guy is actually doing this beyond his wildest dreams of success then why is he writing a book about it, to share with everybody else? There must be some risks in here. And by the way, if everybody in the market started reading this and doing it then wouldn't that erode the advantage in the first place?"

Cory Shepherd: But bigger picture than that is the fact that it is a factor that's been identified by academic research. And Paul and I happened to be going to an investing research conference the next week, where this came up and I said, "Oh, momentum, this is perfect." And what they said is academic studies have proven that this is a consistent factor, but here's the problem, it's over such a short time period of that momentum fading away that you have to keep trading on a regular basis. So short-term capital gains, or just the trading costs that you generate in the portfolio tend to erode the gain that you got. So you literally could lose by winning with this strategy. And it's so subtle and so tricky, but that's why we do what we're doing in bringing all this information to you, 'cause there are so many things going on. Now, Paul, tell us about the four that really are worth your while over the long-term.

Paul Adams: Okay, very simple, okay? And these are areas where we get additional return and yet we do have some additional risk, some additional volatility and yet we're compensated for it. So that's key. We're not going... This isn't about being risk-free, this isn't figuring out some amazing ninja thing that we're the only ones in the world that know about, the research is out there, this is out there. The trouble is, it's not... I would

say in many ways it's not sexy enough for people to use and hold strategy. There's so many things that are attractive that seem to distract people away from this and that's usually what ends up crushing them later.

Paul Adams: So first is, the market. Stocks, outperform bonds. Now, this doesn't surprise anybody but it is the first of the four factors where if you look at all the way back to 1926, the average gross return of the S&P 500 was 10% versus 3.5% for treasury bills. But next we have this thing called standard deviation. Standard deviation is often time shrouded in mystery for people. For ease of this conversation, think of it as, if you're hoping that the line, the slope of the growth of your S&P 500 over years and years and years, would be 10% then it would be normal to have a 30% year, that's 10% plus 20 it would also be very normal to have a -10% year or 20% below the slope, that is what they call one, the standard deviation.

Paul Adams: We won't go any deeper than that today, but just think of it as above or below the anticipated slope of growth. Now, I think it's easier to just look at that as units of risk, very little risk, a standard deviation of three on treasury bills, and it's 20 on the Standard and Poor's 500. But it's a lot more return. Next, let's do size. Small companies over time, produce better returns than large companies. Now, we're comparing here to the Standard and Poor's 500. This is where people end up with a misnomer though. Standard and Poor's 500 back-tested in 1926 is 10%. Small cap is 11.74. Now, most people look at that and they discount it, Cory they're like...

Cory Shepherd: Like, "That's not that much more."

Paul Adams: "That's 1.7%, what's the big deal?"

Cory Shepherd: Yeah.

Paul Adams: But it's not 1.7%, it's 17% higher. Just picture yourself if both of these were a million dollars invested at the beginning of the year, based upon the average, the S&P 500 returns you \$100,000. But the small cap based upon the average gets you \$110,700. That is 17% higher in actual return, but we also pick up additional risk, that standard deviation is higher for a small cap than it is for the Standard and Poor's 500. Now, sometimes when people are challenged trying to remember the small cap, why does small cap return more over time? Well, some of them fail, but also some of them become unicorns. Like Google, at one point was a small cap, right all these...

Cory Shepherd: Microsoft.

Paul Adams: Yes.

Cory Shepherd: Microsoft was a lot riskier to invest in in the early 90s than it is today, and no one expects Microsoft to grow as rapidly today as it did way back then.

Paul Adams: It's very difficult to go from being growing to a unicorn, being a small company becoming unicorn. Once you're already unicorn, what are you gonna be? Like a unicorn that shoots lasers out of its eyes. [laughter] It doesn't... Super unicorn of some kind? There isn't another unicorn level. But then we have value factor. Value, are those companies that have a... The price to earnings ratio is lower. So they have... It's not price to earnings, it's the lower book to market meaning what are the assets that they own versus what are they trading for in the marketplace?

Paul Adams: It's not a earnings, it is the book ratio of the company, meaning, do they own a bunch of real estate, a lot of factories, intellectual property, etcetera, that has separate value beyond whatever it's trading for in the marketplace and the better that ratio, the better it returns over time. Now, this is almost a 2% difference, or in that case, I think it ends up being a almost 20%, like 18% differential, in return with the standard deviation going from 19 to 24. So you have more return again with a little bit more risk. Now, the next one is Cory's favorite to poke fun at.

Cory Shepherd: Shocking. It's just shocking. Profitable companies tend to perform better than non-profitable companies. Now, I know that in the '90s in the tech bubble, this was revolutionary thinking, 'cause you really only needed a website and a great idea and money was just pouring at you and stock prices were going up, but you've got earn... Money's...

Paul Adams: What... I don't know if that's accurate, Cory. I don't know... I don't think you actually needed a great idea during the tech bubble. You just needed a website [chuckle]

Cory Shepherd: Just a good website. That was it, an idea for a website. [laughter] Yeah.

Paul Adams: Yeah, [laughter] you did have to at least own the dot com.

Cory Shepherd: Right. Pets.com.

Paul Adams: But that's... You make such a great point, is that these profitable companies, this, along with some other work actually won, one of the board of directors of Dimensional Funds, a gentleman named Eugene Fama, a Nobel Prize in 2013. And his price to markets theory and this idea that profitable companies outperform the less profitable peers, and they do so with less risk. Now, for the people that really like to nerd out on this and are watching it on YouTube, this is a list of the historical observations of these four factors going all the way back to 1937, each of these windows having a 10-year back test.

Paul Adams: The red shows the years that the premium was not earned, meaning there are several years, and if you get a chance to pull this up on YouTube and look at the chart, or we can throw this in the show notes, what you can do is see that there are

times where treasury bills outperformed the stock market, for a decade. You can see that there are times where small cap did not outperform large cap, but the times that those premiums are earned are significant, and they happened very, very quickly. And if you wanted to see those as a percentage period, meaning how often, over a 10-year period of time, these factors of return, these dimensions of return outperform, so stocks outperform bonds 85% of the time. That's very real, that means treasuries outperformed stocks 15% of the time in back-tested periods. Value beat growth, 83% of the time, profitability beat low profitability 99% of the time, and small beat large 73% of the time. It is a big deal.

Paul Adams: Now, most people don't see these returns. Why? Well, going back to earlier in our episode, we talked about the fact that most individual investors don't stay the course, they jump around. If you took this back-tested period, and I just had this old slide sitting there, it's what I used today, that's a 20-year back test from 1992 to 2012. During that period of time, the S&P 500 yielded 8.21%, but your average investor in equities only got 4.25. That's not just the individual investors' mistakes, these are also mistakes committed by the advisory community, that keeps changing out which asset manager they use for their clients, and by changing out which asset manager they use for their clients, they're effectively reintroducing inappropriate amounts of risk because they're betting on somebody and therefore, producing lower returns. Think about that for a moment. A 20 year period of time where the average investor did 4.25 over a period where inflation itself was 2.5%. Odds are you nearly broke even over 20 years as an individual investor after inflation and taxes.

Paul Adams: So let's go back to just let you guys know what Cory and I feel like you could actually do with what we've talked about today. Well, one of the first things to consider is number one, we bring this up every time is, do you have an actual strategy for the way that you're going to invest? Something that you can understand, something you feel like you can implement and something that you can hold to account, whatever advisor you're using, and that doesn't matter if it's some robo-advisor, because they can change their allocation models, too, on you, and not properly disclose it. So do you have controls on that? And two, does your portfolio have these tilts? Does it have a tilt to small-cap, not small cap instead of large cap, just a little bit more small cap? Do you have a little bit more value? Do you have that? Is there even in a screen inside your current asset management strategy for more profitable companies?

Paul Adams: And if you find yourself not having those, that might be one of the first things you wanna check. If you don't know if you have those or not, reach out to us info@sfgwa.com. We're happy to share our philosophy with you, we can take a look at the investments that you have and see, do you have any of those tilts? Or like many people, are you chasing returns looking at the asset managers that did well over the last few years? And then lastly, set your allocation based upon your loss tolerance, not your risk tolerance.

Paul Adams: Everybody out there tries to almost get you to buy in to taking more risk for more return, but it doesn't matter. If you have a portfolio with a certain level of volatility and that volatility is more than what you personally can take, that you just don't feel like, "I can... If there's 20% downturn, I might lose my mind." If that's the case, then you should be in a portfolio that is not likely to do that, because the worst thing you can do to mess up your portfolio strategy is to have to break strategy unnecessarily.

Paul Adams: The most important thing, set strategy, hold strategy, be patient, rebalance. That is what will serve you as an individual investor with a portfolio type asset. And last, I would say, take time to just bounce off somebody you respect at work, bounce off a good friend of yours and ask what they're doing. Ask them to listen to this episode and talk to them about it. Put yourself in the position where you're actually getting reflective with the people that you care about about money and your long-term financial questions and concerns because if you don't, you may not have a future with that person, meaning one of you is likely not to make it to your old age, and have a work optional lifestyle.

Paul Adams: And imagine being able to do all of this and not have your friends to be able to go with you. Not have your friends be able to go to Hawaii for your retirement party, not be able to have their children and your... Your children and grandchildren and their children and grandchildren aren't able to go on a retreat together because that grandparent can't afford it. That, in fact, we're caring for our future and the future of our friends by just making sure we're all being more aware of our money and taking care of our finances, building toward a work optional lifestyle, because what we want you to be able to do is not just design and build a good life for you, but be in a position you influence that with those you care about. And as always, we hope this has been a contribution to you being able to design and build a good life.

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Episode 142 - The 4-Factor Model *Episode Transcription*

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