Episode #181: Do Your Investments Feel Imprisoned?

Video Transcription

Welcome, everyone. My name is Robert Reaburn, and welcome to another episode of Money Script Monday. Today, we're going to be talking about how to liberate your investments from mediocrity. We often ask the question, for many clients, of whether they feel like their investments feel imprisoned, and that's the title of today's presentation.

What do we mean by that? That's a very emotional term when you say something feels imprisoned, but what we mean by that is, when you look at your investments- when you get those statements in, every single month or on an annual basis, do you feel that something is missing and perhaps your investments are underachieving? For many clients, that answer is yes and a lot of that has to do with the rise of passive index investing over the last 15 years.

Today we're going to be talking about the two core myths that we see out there related to passive investing. The first myth is that index investing is cheap, safe, and diversified. The reality is that none of those are true. When we look at those typical passive index products, whether it's Vanguard or Fidelity, we view that as a communist-based investment approach. That's another colorful term, but what do we mean by that?

When you're investing in the index, what you're doing is you are with no regard whatsoever investing in both good, bad, and ugly companies. The reality is, if we invested on an individual company basis, I can assure you there would be a number of those companies you would say, "I want nothing to do with those firms." What we do when we invest in an index product is we're ultimately providing our money equally across the board. We want to step away from that. We want to introduce a little bit more discrimination into the process between good and bad so that we can put your money to productive use.

Second, the index is not as diversified as you think. That's probably the big thing that we all believe about index investing. Would you believe it if I told you that for every $100,000 that you invest inside an index product such as the S&P 500, $25,000 of that money is going into 5 companies? Why is that? Because a lot of index products out there are market cap-weighted. They reward companies that are already large. They've already gone through the growth phase, so you're buying high and you're selling low because they'd sell companies that have already gone through a very bad period.

Third, we know that there's a hidden cost of index investing. What does that mean? Are they explicit fees? No, they're not explicit fees, but what they are, opportunity costs. When you invest in that index product, there's approximately 70% of the index that are either composed of what we call zombie companies. I know that's a scary term, but those zombie companies are companies where their cost of debt is higher than the amount of earnings that the company is generating. Over time, you're getting that equity degradation. That's 15% of the index. You then have that 25% of the index that we talked about, which is composed of 5 companies that are all over or close to a trillion dollars in market cap, and then you have an additional 20% to 30% of companies that are simply treading water.

When you think of that $100,000 that you're putting in an S&P 500 index product, there's probably only $25,000 of that total $100,000 that is being invested effectively into what we call best-of-breed firms, companies that are in that process of going from good to great, that we would love to invest in on an individual basis.

That's Myth #1. Right off the bat, we know A is not that safe because we're investing in a lot of bad companies underneath the water. Two, it's not that cheap because we're giving up a lot of return by deluding our overall investment power into bad firms. Three, it's not that diversified because25% of the index is invested in 5 companies. On each sector within the S&P 500, close to 30% to 50% of each sector's weight is composed of the top three companies. Concentration across the board.

The second myth is that you can't outperform the market. What's kind of ironic about this second myth is that Vanguard, and Fidelity, and a lot of these platforms that have index products will go out there and say that but then, in the next sentence in the fine print, they'll say 85% of managers underperform the market. That means from a mathematical perspective that 15% are outperforming, right? The question is, what are those 15% doing that the 85% are not doing? The reality is that there are a few things that we can do as investors that don't necessarily pertain to stock-picking but overall can increase the probability that we make a good stock pick when we're managing portfolios.

The first thing that we should do is get rid of automatic rebalancing. We hear that in financial literature across the industry. Automatic rebalancing. Once a quarter, we automatically rebalance. That's what we call communist investing. What do we mean by that? What we mean by that is that you are rewarding companies that have done a poor job executing their corporate plan, and you're demoting or punishing best-of-breed companies.

Imagine if you bought Apple right as the iPhone first launched in 2008, you would be selling Apple every single quarter for the next 12 years. Why? Because it did well.

Meanwhile, you would be buying most stocks, why? Because they did bad and are losing market share and the stock prices are getting hit. That simply doesn't make sense. We live in the U.S. We live in a capitalist society. We live in a society that rewards winners, and we punish losers. We want to make sure we're taking that same approach when it comes to investing.

The third is we want to beware of that wolf in sheep's clothing. What we mean by that is the vast majority of mutual funds out there that we look at are closet index products, and 85% underperform. Why? They own too many stocks, they automatically rebalance out of their winners and into their losers, and lastly, they are closet index products, which means they look 98% like the actual index. You're paying an additional 0.5%, 0.6% in fees but you're getting an index product where you should only be paying 0.1%. Both are bad, but one is more expensive and that feeds into the fact why so many mutual funds underperform. It's hard to outperform the index when you look exactly like the index. The only difference? You charge a higher fee. We don't believe in that approach. It's good to be different, it's good to be confident, and it's good to take a narrow and active approach to investing.

That gets us to the solution, right? We believe in an American-based approach to investing, which is to focus on companies that are executing today, will continue to grow tomorrow, and will continue to capture and disrupt their competition and capture market share over time.

First, we want to reward success and punish failure. When we look at our portfolio, when we're constructing that opportunity strategy, it's like the American Idol where you're constantly auditioning companies. Over time, you narrow the field. What are we doing? We're looking to see what that overall corporate plan is, how well is the company executing through time, and then ultimately letting that stock grows as the proportion of the overall size of the portfolio.

Meanwhile, you know what? We're going to get some stocks wrong here and there. When we do get it wrong, we move the stock to the sideline, we go to cash, and we redeploy that cash with another contestant for the portfolio. In other words, another farm team member stock that we're considering for the portfolio.

Third, we want to reduce portfolio friction, and we want to narrow the field. What do we mean by that? By reducing portfolio friction, what we're saying is we want to reduce the stock count. We want to keep that portfolio construction below 30 stocks but above 20 stocks. We want to optimize diversification. In other words, as long as we own north of 20 stocks across different sectors, across different themes, and different areas of secular growth, we can achieve the maximum benefit of diversification.

We also want to make sure that we're not owning too many stocks. Once you start to own above 30 stocks, the benefit of diversification starts to fall off, and all you're doing is diversifying your ability to outperform the market away from the portfolio. Stay focused. Stay high-convicted in best-of-breed ideas and companies that are going from good to great.

The last thing, and I think perhaps the most important thing, is to hire a swing coach. When we think of investing, the number one mistake that is made with both institutional investors, retail investors, mom and pop investors across the country is they don't have a swing coach. Tiger Woods in my opinion is one of the most dominant golfers in the history of the sport, but he had a swing coach. If the number one golfer of all time can have a swing coach, certainly you can afford to have a swing coach as well. We can see that.

With investors that are in an index S&P 500 product, the returns that they're experiencing when they use an advisor are the difference between 4% annualized and 8% annualized. We just have to look at last year to see the difference. Did you panic? Did you sell? Did you raise cash in March? Or were you calm, collected, and cool and ultimately realize solid returns last year?

That's what a swing coach helps us do. It's not to pick the best stocks in the world. It's not to try and market time, but it's to stay focused on the long-term, make sure the financial plan stays intact, and try and find the best portfolio managers across the country to manage your money. That's their job. They're there every single day to make sure that the products they select are doing their job. If they're not, they're going to do the same thing we do when it comes to portfolio construction, and that is making sure that bad products are sold and good products are rewarded. That's the difference between a portfolio that can underperform through time and the difference between those portfolios that ultimately generate an active outperformance versus the market.

That's all we have today. Thank you again. Have a great week. If anyone has any questions, please reach out to one of our affiliated advisors to learn more about how an active management approach to investing may be able to assist your portfolio. Thank you again and have a great day.