Rodrigo: **00:06** Hello everyone and welcome to ReSolve's 12 Days of Investment Wisdom mini-series, where Michael Philbrick, Adam Butler, Jason Russell, and myself, Rodrigo Gordillo, will explore timeless evergreen principles that will help you and your clients achieve long-term investment success. From the importance of asset allocation, thoughtful portfolio construction, and maximum diversification, our aim is to offer you a comprehensive framework for a more thoughtful investment approach that may change the way you view the complex arena of investing altogether. We hope that you enjoy the series as much as we enjoyed putting it together.

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Mike: **01:10** All right, welcome back. Hot on the heels of our discussion on capital efficiency, the prudent investor rule, the role of a fiduciary in that, how you might think about vol targeting and a whole suite of opportunities to actually impact client portfolios in a positive way. But they do provide some discomfort. And so, today we're going to talk about getting comfortable with being uncomfortable.

Adam: **01:39** That's right, yeah. And specifically we're going to talk about the axis of discomfort, which is really the reality facing many retirees or those who are approaching retirement at the moment where you've got a- a future of fairly low returns, given current valuations of domestic U.S. equities and high rate bonds. So, you've got to make some choices. You're going to be uncomfortable because you've got to increase your savings rate in order to save more for retirement because you can't expect to get the same returns that we've seen historically.

Alternatively you can reduce your expectations for retirement lifestyle or maybe push out your expected retirement age, um, you know, if you were expecting to retire at 62 or 63, maybe you push that out to 65 or 66 and then, the other potential step you can take is to take a step into things that are less familiar. Whether that means embracing global investments, maybe that just means foreign stock markets, maybe it means emerging markets, or emerging market bonds, and then also considering alternative sources of returns, a lot of which we discussed in- in fairly great detail in previous podcasts.

So, that's the axis of discomfort, increased savings, reduce your retirement lifestyle expectations or embrace unfamiliar investment categories.

Mike: **02:57** And I think this is particularly acute when you actually look at the assumptions that are going into the financial plans or actuarial calculations on these ah, assets with long-term purposes, like those for retirement and pension funds. So, if you look at the individual investor right now, they're- they're putting 10.2% as the expected-

Adam:	**03:18**	In surveys, yeah.
Mike:	**03:19**	Yeah, in surveys into their expected return and- and this reflects recency buys, home country buys for the whole myriad of items that are reflecting that. You then have a- a slightly more thoughtful pension industry that is saying, "Well, we think it's 7.5, we would sort of still be a little bit eyes wide open, looking left and looking right on that number, and then finally you've got Vanguard, who is currently suggesting that you know, probably a good- good estimate is half of the average historical return on global asset, equity assets of you know, sort of 4.5 to 6.5%
Rodrigo:	**03:57**	And that's on global.
Mike:	**03:58**	Right.
Rodrigo:	**03:59**	So, that's already going out on the more, uncomfortable limb.
Mike:	**04:05**	Right. That is that first step that we talk about and- and of course, let's talk about getting uncomfortable. So we know that there's a large home country bias across the world. You go through any country in the world and people generally like to own what they see every day. They have familiarity with it, there's some, there's just this, I know what it is. This feeling of comfortable, it's a halo effect. And what's so interesting is, I had the opportunity to sit in on a seminar with Professor Shiller and they were launching a product in Canada and so, there was a room full of portfolio managers. There was probably, maybe a hundred of us there? So, representing billions of dollars in A.U.M. And came to the question and answer period, and Shiller is there you know, taking questions, portfolio manager thoughtfully puts his hands in the air and says, "Well, you know, given that the current CAPE ratio for American Equities is approaching 30, 28 or whatever it was at the time, you know, "What should we do? What, everything's expensive, how- how should we operate?" And Shiller paused-
Rodrigo:	**05:10**	And he says- he says, "There's nothing, because nothing's cheap-"
Mike:	**05:13**	Nothing's cheap.
Rodrigo:	**05:14**	What should we invest in?
Mike:	**05:15**	Yeah, what- what should we, what should invest in? And Shiller tilts his head and says, "Well, nothing's cheap?" So, well no, you- you have CAPE ratios in- in Russia, in Czech Republic, in Turkey, and Greece that are the 5 to 9 range-
Adam:	**05:28**	The mid single digits.

Mike:	**05:29**	Yeah, and so, there's lots cheap. And with no word of a lie, the whole room sort of scoffed and chuckled. Together they just scoffed, like ... no one can do that. Well, of course, no one can it, that's where the excess risk premia lies. That's why it's there because it's hard to do. It is uncomfortable.
Rodrigo:	**05:57**	But it is, it is uncomfortable. And it's crazy how that home country bias works everywhere, right? We're just sitting down with one of our newest employees, who is fresh out of the US. And I was telling him how in Peru there's a huge home country bias. And he's like, "What? I thought that like the global default was to invest most of your money in the S&P 500?" No. The vast majority of Peruvian investors like, over 90% goes into the Lima Stock Exchange. We think it's kinda silly that Canadians who represent 2 and 1/2% of global market cap invest, what is the number? One of the largest banks just came out with a survey-
Adam:	**06:30**	Yeah, yeah. So- so, my buddy is the ah, head of retail at one of the major Canadian banks, so I just asked him a couple of years ago to go through their total wealth book and identify what percentage of their assets from Canadian investors are invested in Canadian assets, Canadian stocks or bonds. And he, his analysis suggested that 87% of their wealth book is in Canadian stocks and bonds. 87% again, right? Reiterating that Canadian stocks and bonds represent about 2 and 1/2% of total global market cap. So, again just reiterating that. There is strong home bias-
Rodrigo:	**07:02**	And the previous stock markets, a fraction of that and the same thing happens, so we get it. This is a real thing and we have to manage to that, right? We as-
Mike:	**07:09**	What it provides though, is it provides for a willing loser. It provides for someone who wants a certain amount of comfort and is willing to give up excess returns to those who are willing to be more thoughtful about diversification across many different domains and axioms, right? So, this is an opportunity but, we've gotta be, we've gotta get our heads around that. We've gotta get our heads-
Rodrigo:	**07:32**	Sure-
Mike:	**07:33**	Around being comfortable, learning right down to the grass roots because when it doesn't work, which the last 10 years is representative of that, if you're a U.S. investor and you've had that U.S. home country bias, it's been a huge tail wind. There has been nowhere else in the world to bother-
Rodrigo:	**07:47**	Diversification does not pay-
Mike:	**07:48**	Yeah, and so, what you don't want to do if not give up on diversification precisely at the wrong time. You absorb all the risk and you get none of the returns. And so, global is one thing, but then it goes into what we've talked about in the previous days, which are all the other alternative options, leverage aversion okay, should I be using leverage in portfolios to target volatility like we talked about in the last episode?

Like all of these are yeah, they're going to require that you stretch a little bit. But, the stretch is worth it in our opinion. We would, we would urge you to consider it-

Rodrigo: **08:20** Well, you need the, you need the stretch from the point of comfort that you're in. So, if you have done zero, I think it's going to be difficult to convince anybody that has been in the business for 20 years to start adding 50, 60, 70, 80, 90, 100% of this (laughs) stuff. So, there is a reality out there that the vast majority of retail money out there has been used to a certain type of investment. Signed up for something very, very different that what we're espousing. And we got to take that into account, right? There is that-

Mike: **08:48** Absolutely-

Rodrigo: **08:49** If you are that advisor, then you are still going to be uncomfortable. You're going to be comfortable in that you're going to continue to espouse what you've always espoused, but now you have to have the uncomfortable conversation with investors on what they need to do to stick to that type of portfolio, and that is saving more, spending less, working later.

Mike: **09:09** It could be. I mean-

Rodrigo: **09:10** So, that's fine. That's the idea of getting comfortable being uncomfortable and you're, and you're minimizing tracking error, you're giving them a level of comfort in what they own, but there's the discomfort on the other side.

Adam: **09:20** The important take away really is, that it- it's incumbent on advisors who sit at the nexus of their client's success to have an honest, candid conversation with each client about the realities that they're facing.

What specifically are those realities? Well, on the bond side, we know what we can expect for returns on high rate bonds for example, if you look at the Barclays Aggregate Bond Index, the current yield to maturity is 3.44%. And so, over the next 10 or 11 years, that's what investors should expect on global bonds. We know that Vanguard expects 4.5% ish on- on U.S. equities. Maybe slightly higher on certain very cheap, foreign equity markets. But we're sort of in the neighborhood of 5, 6, maybe 7% if you really want to push out the risk spectrum on global equity markets anchored against a 3.5% return on bonds. So, a 60/40 portfolio, you're looking at somewhere in the neighborhood of 4, 4.5%, that's before fees and taxes. So, I mean these are just, you know, we're not really pushing the envelope here, we're using Vanguard estimates. These are right down the fairway. We could really use aggressively pessimistic estimates, that's not really where, our- our point. Our point is, find a reasonable estimate for returns, have candid conversations with your clients and then allow clients to determine what balance along this axis of discomfort is right for them, right-

Rodrigo: **10:52** The utility function, right? We're- we're not, it's, we're not trying to espouse that there's one way, there's one optimal way of- of investing client's money. I mean, there's a difference between maximizing the time weighted rate of return, and maximizing the money rated weight of return, right? And what we want to emphasize is that what you need to do, is you need to educate your client's and employ a methodology for your client's that's going to maximize their chances of success.

Mike: **11:18** Yep-

Rodrigo: **11:19** And that is a combination of all three. I mean, there's, I have no beliefs that we're going to get anybody on this podcast, listening to this podcast to do 100% global alternatives. There's very, there's going to be a very, very few amount of advisors that are going to do that and- and it's because they understand their clients better than anybody else.

Mike: **11:36** It's not just advisors, it's pension allocators too. They have career risk in deviating too much from the reference portfolio generally provided in their industry and I do think that if you are in that position whether you're advising pools of long term assets or individual assets, figuring out the tracking error that the person or entity is most susceptible to, is of paramount importance.

So, if someone has a number of friends and they're all Apple employees, well, if you sell their Apple for them and all of it, because you want to diversify and all of their friends are still holding their Apple stock, you're going to be a very unpopular advisor even though you're trying to do the right thing by diversifying their portfolio, so understanding what the tracking error is, what the minimum effective dose is, so what I want to do is, I want to buy their tracking error with the absolute, what's going to keep them on plan-

Rodrigo: **12:36** That's- that's right, yeah.

Mike: **12:37** And that- that's the amount I want to own. And that- that's going to be, that's going to be a nuanced conversation, that's why you're a professional, that's why you're a craftsman-

Adam: **12:43** You're never going to get it exactly right-

Mike: **12:45** Exactly. And so, then- then that becomes one part of the portfolio and the- they'll say to you, "Well, this is doing that." And you say, "Yes. There it is." It's exactly that. It- it- it tracks that tracking error, it- it's exactly that, whether it's S&P 500, then buy an S&P 500 ETF cheap, great.

So, we've got the tracking error taken care of. Now we need to manage the rest of the portfolio around that optimizing that portfolio for actually taking into account that tracking error ... issue, right?

So, if it's, if it's a large U.S. stock index or individual security, then you should factor that into the rest of the allocation throughout the portfolio, and then you should think about diversifying across global asset classes, alternative strategies, factor premia, to the extent that you're able to if you're in the position of being a fiduciary, you have more flexibility and actually a higher standard that you are required to meet. And again, all of this is, by the way, advisors, if you're kind of squiggling around in your chair and you're feeling a little uncomfortable, it's time to get comfortable.

Rodrigo:	**13:45**	(laughs)-
Mike:	**13:46**	With feeling uncomfortable. Because this is, yeah I get it, it's uncomfortable. What we're trying to do is provide some framework to help you convey these ideas to your clients to really get traction where the rubber meets the road. What we don't want to have happen, and- and Nassim Taleb tells this story the best. What I don't want you to be, is the turkey. Right, I get it. U.S. stocks have done really, really well over the last 10 years. It has not paid to diversify. Alternate risk premium, style premium have not done well (laughs) in 2018. I don't think anything's done well in 2018. Okay, so now, let's lay that over the life of a turkey. The- the turkey's born, he's nurtured by the farmer, he's fed by him every day. The pen is guarded to keep the foxes out in order to have that turkey reach its full potential.
Rodrigo:	**14:42**	And when the turkey crunches the numbers, he sees that with a higher level of confidence-
Adam:	**14:48**	Every single day, he becomes more and more confident.
Rodrigo:	**14:51**	Every single day, there's more data to back up that they are truly loved by their masters.
Mike:	**14:55**	Correct. And then, Thanksgiving comes ... followed by Christmas.
Rodrigo:	**15:00**	(laughs).
Mike:	**15:01**	Boy, it is a tough 6 weeks.
Rodrigo:	**15:03**	(laughs) followed by Christmas.
Mike:	**15:05**	It's a tough 6 weeks in the turkey world right now. (laughs) we're- we're right in the heart of the tough (laughs). So, you (laughs) so, you know, you have all this, the turkey has all this data reinforcing the bias that he already has, which I feel is the same sort of thing going on in- in markets in a number of circumstances, and by the way, if we go back through time, this is something that rhymes, it- it you know, with the bricks, the grimples, the diversification of 2000, which was Sun, Microsoft-
Adam:	**15:27**	The nifty fifty's-
Mike:	**15:28**	Yeah, yeah, exactly. And the nifty fifties is a great example. So, we- we- we, this is not new. We have past precedent for this and so, I think, you know, on that note, don't be the turkey (laughs).
Rodrigo:	**15:41**	Sure. You know, I just want to add one more thing before we go-
Mike:	**15:45**	Of course-

Rodrigo:	**15:46**	I mean, I, we're talking about getting comfortable being uncomfortable and this just came to me. Investing is uncomfortable always. Whether you're 100% domestic, equity bond investor or not. The difference is that sometimes the dosage varies. And so, it can comfortable. For 10 years it's been very comfortable but we all felt, anybody that thinks back to the great financial crisis, that dose of un-comfortability was-
Adam:	**16:10**	Or discomfort?
Rodrigo:	**16:11**	Thank you,
Mike:	**16:14**	I like un-comfortability.
Mike:	**16:15**	Yep, let's go with that one.
Rodrigo:	**16:26**	That- that's a real word in Spanish, you guys-
Adam:	**16:17**	(laughs).
Rodrigo:	**16:20**	That level of discomfort was massive-
Mike:	**16:22**	Sure.
Rodrigo:	**16:23**	I remember advisors not being able to return the calls to their clients, where they- they were just not coming into work. It- it, clients not looking at their statements for months on end. The level of-
Adam:	**16:35**	Hey, I had advisors calling me at 4 a.m. for conversations about what was going on in Asia. That was, that was a-
Rodrigo:	**16:40**	Therapists-
Adam:	**16:42**	Definitely above-
Rodrigo:	**16:43**	Everybody was getting therapy, they, like you- you were going to get a big, whopping dose of discomfort-
Mike:	**16:48**	Mm-hmm (affirmative)-
Rodrigo:	**16:49**	The question is, do you want to dole it out a little bit every year, by being this type of uncomfortable or do you want it to happen like the turkey. And so, you know, it's always uncomfortable-
Mike:	**17:00**	That is a, that is a great piece of insight. Here's what I've learned over whatever, however many years I've been doing this, 20-
Adam:	**17:08**	How many is it?

Mike:	**17:09**	I- I don't wanna say-
Adam:	**17:10**	(laughs).
Mike:	**17:11**	It's 20 something (laughs). And ah, when I'm feeling comfortable, I'm terrified.
Rodrigo:	**17:16**	Oh, that's so true.
Mike:	**17:17**	(laughs) And when I'm uncomfortable, I'm like, this is pretty good. This is going to turn around.
Rodrigo:	**17:21**	I'm very excited right now.
Mike:	**17:22**	Yeah, me too (laughs), me too. It is, it is the time to ah, evaluate these types of strategies, it is, again, if you would like to get the superior, money weighted rates of return and keep in mind, at ReSolve, we always talk about what our goal is. We want to be in the Hall of Fame for risk adjusted returns for our clients and our products-
Adam:	**17:43**	Realized risk adjusted returns-
Mike:	**17:45**	Yeah, realized risk adjusted returns. And in order to do that, you, there's a certain amount of discipline and rigor that's required and there's a certain amount of acting in the face of what looks to be daunting facts and figures and it- it- it's-
Rodrigo:	**18:59**	And a massive amount of education that goes along with it.
Mike:	**18:02**	Yeah, without a doubt.
Rodrigo:	**18:02**	We are seeing inflows for some our ah, the- the strategies that we talk about the most-
Mike:	**18:07**	Yep-
Rodrigo:	**18:08**	In the worst possible-
Adam:	**18:09**	That's part of the hard work, or part of the discomfort is, some of the hard work that's required in order to learn about these alternative sources or return and when they struggle and when they thrive and how to put the pieces together. You know, these are, if you're not ... motivated or passionate about these topics then it's hard work and it's uncomfortable, but that's just another source of edge.
Mike:	**18:31**	Yeah. Is it, is it a shock that we're going through this style premia bear market if you will, at the point where we have a market capitalization bull market? And if you go back to 1999, there was this similar set of circumstances that occurred where there was one set of portfolios that worked, it was market cap, it was a U.S. dominated market. There was a tech bubble going on, at the same time.

Rodrigo:	**19:00**	Well, isn't value dead right now? Like, it's set forever, right (laughs)?
Mike:	**19:03**	And quality was dead back then too-
Rodrigo:	**19:04**	That's right, quality and value were dead.
Mike:	**19:05**	At the maximum point of under performance-
Rodrigo:	**19:07**	Warren Buffett was ah, totally, totally lost-
Mike:	**19:10**	Had lost, had lost his stuff-
Adam:	**19:13**	Had it under performed by- by 69% over ah, the period of '99-2000.
Rodrigo:	**19:18**	Yeah.
Mike:	**19:19**	But, did he flinch? Did he go away from the idea of investing in quality companies for the long run? Did he blink? He did not blink. And what's interesting, in this go around, it's the defensive types stocks that Mr. Buffett would normally buy that have actually participated the most and have a coincident rally with U.S. equities. But there are factor premias that are really kind of decimated, you know, if you look at the 10 year rolling return for trend or value, it's been quite a tough go. And that to me-
Rodrigo:	**19:54**	But-
Mike:	**19:55**	That's what gets me excited-
Rodrigo:	**19:56**	What happened right after is that the best managers were value managers during the- the 2003 tech crisis, right?
Mike:	**20:00**	Yep.
Rodrigo:	**20:01**	That's where you wanted to go. Anyhow, I think we've beaten that horse to death (laughs). All right. Cool. So, that is it for episode ...
Adam:	**20:10**	8.
Rodrigo:	**20:11**	8. We have 4 more to go. And we will be talking about ah, random series of very important topics for practitioners, so, stay tuned. We look forward to- to seeing you next time.

Thank you for listening to our 12 days of Investment Wisdom mini-series. You will find all the information we highlighted in this episode in the show notes @investresolve.com/12 days. You can also learn more about ReSolve's approach to investing by going to our website and research blog at investresolve.com, where you will find over 200 articles that cover a wide array of important topics in the area of investing. We also encourage you to engage with the whole team on Twitter by searching the handle @investresolve and following Adam, Mike and myself. If you're really enjoying this series, please take the time to share us with your friends through email, social media, and if you really learned something new and believe that our series would be helpful to others, we would be incredibly grateful if you could leave us a review on iTunes. Thanks again and see you next time.