

**Rodrigo:** 00:01:47 All right, all right, all right. Welcome to Friday.

**Mike:** 00:01:50 Little McConaughey there. All right, all right, all right.

**Rodrigo:** 00:01:52 That's right. All right, all right, all right. Mr. Balchunas, how are you today?

**Eric:** 00:01:56 I'm doing well. That was a pretty good McConaughey, actually, your second one.

**Rodrigo:** 00:01:59 My wife does it all the time. So, she's a -- ...

**Eric:** 00:02:01 Oh, yeah? Pretty spot on. Yeah.

**Rodrigo:** 00:02:04 She's a big fan of his work.

**Eric:** 00:02:05 I saw that movie in the theaters. That's how old I am.

**Rodrigo:** 00:02:06 I hope she's just a big fan of his work. *Dazed and Confused* was the -- Dazed and Confused crowd here. Isn't that his first piece of work?

**Mike:** 00:02:19 I think those are the first three words that he ever said on camera.

**Rodrigo:** 00:02:21 That's right.

**Eric:** 00:02:23 When I saw the movie I just -- it's crazy how much of a career he had given that role. It just seemed like, it's like a goofball, character actor in that one movie, but amazing. He was sort of like Sean Penn, in *Fast Times*, Sean Penn, you would never guess that guy would have had such a career.

**Mike:** 00:02:42 Yeah.

**Rodrigo:** 00:02:43 So, I was going to read his book, *Greenlights*, but I heard that he narrated his own audiobook and I had to do it. I think anybody here deserves to hear McConaughey talk about his own life. Is it as McConaughey as you can imagine it? It's pretty established.

**Mike:** 00:03:02 Does he have the whistle as he does his own voice?

**Rodrigo:** 00:03:07 It is outrageous. His narration is outrageous. It's so McConaughey it's almost like he's doing himself.

**Mike:** 00:03:15 I do like it. Anyway, but let's ditch McConaughey. We got Balchunas here.

**Rodrigo:** 00:03:20 We got better authors here.

**Mike:** 00:03:21 Yeah, fuck McConaughey, said in the great words of NWA. Anyway, by the way, and on that note, we will have a wide ranging discussion. There might be a swear

word or two. So, this is not a place to get investment advice. This is education and entertainment. And today we're going to talk with one of the moguls of finance about one of the moguls of finance, which is *The Bogle Effect*. And Mr. Balchunas, you dove in feet first, head first, and looked at all things Bogle. I have definitely read a couple of his books previously. So, I'm looking forward to the new knowledge that you bring to the table and what The Bogle Effect is all about and how that came to be. And I think, does it start with him writing a university paper or something like that, his research paper which he put out, defended, and then started to build this company based on that? How did it all start?

**Eric:** 00:04:26 You mean, how did he start?

The Bogle Effect – Beginnings

**Mike:** 00:04:28 Yeah, how did he start? How did this avalanche start of trillions of dollars saved for investors?

**Eric:** 00:04:35 Yeah. It's a really weird story. I didn't realize the amount of specificity involved. Starting at Princeton, this is fascinating. First of all, he gets a scholarship to Princeton, he couldn't have gone otherwise. And he's in the library looking for something to write his thesis on, his senior thesis. And he just glances, he gets a copy of, believe it's *Fortune*. I'm going to double check, *Forbes or Fortune*, yes I think it's *Fortune*. And he pages through, finds an article, big money in Boston or something. He goes, oh, this is interesting. I'm going to write my thesis about this. And it's interesting, I looked at the magazine cover, it doesn't have the table of contents. It was just this picture, almost like The New Yorker, just one big picture. And it wasn't about mutual funds, so he had literally page through this magazine.

I also looked to find out what other magazines would be lying around in December, 1949. And the cover of *Time* featured Conrad Hilton. So, had he picked up *Time*, would he be the low cost hotel guy? We'll never know. But it's crazy how much chance plays into stuff like this. But he read it, did his thesis, and the thesis got him hired at Wellington, which is a mutual fund company. Worked there, they loved him, he was made CEO at 35, really young. And basically, his first task was to figure out how to get money in store, stop losing assets, because in the 60s, everything was going to high growth. Kind of reminds you of the ARK situation. It was like everybody was Cathie Wood at the time, right? Some of these valuations were crazy. And his Wellington Fund was conservative balanced and it was losing assets. And they had to figure out what to do. So, as he said it, I was selling bagels, but everybody wanted doughnuts. So, he wanted to team up with the equity manager. He finally went through four or five people. One of those people was the Capital Group, and one was Franklin, and he was pretty good friends with those guys. Had he teamed up with them, I don't think we'd have a Vanguard.

But anyway, he got to the fifth choice, which was this company called Thorndike, Doran, etc., and they had Ivest Fund, and it was high growth like ARK. Teamed up. Effectively, he gave everyone a voting control of the company. And to make a long story short, they did good at first, but then it all fell apart when the 60s fell apart. And 1972-73, the market was down I think about 35%, and their growth fund was down worse. Brutal. And so everybody, they started fighting with each other. Bogle was like, you ruined my company. They're like, well, no, you're awful. And they had what's called a bifurcation period. And ultimately, Bogle got fired. And so he thought he was done. But then he realized he was actually the chairman of the funds themselves, which is a weird, as you guys know, the funds actually contract ... so he still had some control.

So, they figured out, well, if I control, let's come up with a solution. And one of the things his solution was, he had like five different versions, but one of them was to mutualize the whole company, Wellington. They didn't want to do that. But they did allow him to have a back office company that would do the paperwork, and the administration functions and not investing. And they made it mutualize so that it wouldn't look like he was in it to get rich or to compete with them. And he had said earlier, he thought the mutual structure was good, because it's -- you serve one master kind of thing. He had written that. But I talked to people who most of them think it was a virtue by necessity, he was just trying to save his job. It wasn't really an altruistic vision.

And so that, ultimately, is how Vanguard got created. And I don't think -- once the -- it was almost a freak accident. I mean, it's really rare that the investment advisor, and the fund chairman would be at odds like that. And so the whole situation is just really quirky. And most people probably would have left and gotten a different job somewhere. He stayed and fought. So, there's a couple of different things that had he gone a different direction, you're just ... going to get a Vanguard. And he had a bunch of kids at the time, I think you had like four or five -- I think he had six kids total. But some of the kids -- he could have easily just gone to like one of these big asset managers and cashed out. But he chose to do this other path and that's it. They ran a back office company, and ultimately, he slowly built on it. And the first thing was to add the index fund, which technically wasn't managing money. That's another crazy serendipitous loophole. And then over time, you're able to launch active funds again, and international funds and they built out this whole company, but it really started as a back office company. And that story...

And here's another thing that was fascinating. When Vanguard started, they had 80 straight months of outflows. It's crazy considering they haven't seen one month of outflows since, I think one month in like 30 years or something like that. But they had 80 straight months. And it really is a fascinating story. And then it took them 10 years -- 25 years to get to 10% market share. So, a lot of

the book is me saying how this guy was able to sell something as average, and operate outside of the system. He wasn't giving loads so he had to sort of -- it's almost like making a movie and the cable -- none of the networks at the movie theaters will actually hold it. And so you're having to sell this thing outside of a complete system. And I thought that was interesting.

## The Uniqueness of Mutualization

**Mike:** **00:10:02** You're outside the normal distribution network entirely. Can you talk about or do you know much about the uniqueness of the mutualization and how that played in? I do believe there's, like the deadline for that is approaching. Isn't there some sort of copyright or trademark or something that prevents other companies from doing what they did? And are you familiar with all of those machinations?

**Rodrigo:** **00:10:27** Yeah. But start with what it is, right, why that was so special, because it was interesting, it seems like an altruistic -- it is an altruistic element but it wasn't, it seems to me that it was a serendipitous reality, not a ...

**Mike:** **00:10:40** Crisis, necessity, change.

**Eric:** **00:10:43** Yeah, I mean, I try to -- the book's favorable towards him, but I tried to highlight works and the convenience of it all. I mean, remember, he was working at Wellington, he was very happy there. That's an active fund company. In fact, I interviewed 50 people and one of them was Jason Zweig, who pointed out, he sent me this speech that Bogle gave, I believe, in '71, which was three years before Vanguard. And the speech is him defending active managers against the S&P 500, which The York Times wrote an article saying they're not that good. And he's like, no, that's the wrong benchmark. And you can tell it's Bogle, it's the same voice, but it's making the opposite argument. And I had to put that in the book because I wanted everybody to see that you could do great things without being like Jesus.

I mean, he clearly wasn't -- it wasn't like, he just hit his head on the toilet and said I'm going to do all this great stuff. A lot of it just kind of was circumstantial. He did make the most of it and he was really good at selling and marketing and talking and communicating, and that helped a lot. And I think he truly believed in it once he found this, but the mutual ownership structure, to answer your question is, it's unique in that the funds own the company and the shareholders, the funds, so the shareholders vote for representation on the funds, which then is the board of directors. So, the reason that's powerful is that every time they have assets or extra profit, they would vote to lower the fees. Obviously, they obviously spent money on the company a little bit, but predominantly, what would be in the best interest of the shareholders is, I want lower fees. And so you rinse and repeat that for 45 years, and the fee went from like 45 to three.

And what's interesting to me is that nobody really was asking for low fees back then. And so the idea of doing this before people were asking for it was also interesting to me. And I have this interesting dichotomy in the book where it's 1987, and he's giving his annual speech to the Vanguard crew. And that's the year *Wall Street* came out where Gordon Gekko is like, "*greed is good*". And I just imagined Bogle speaking in 1987, sounds exactly like he did in 2015 or 1995. And yet, the culture really, about greed and Gekko became like, obviously, he brought in a lot of people to Wall Street, actually. I mean, he kind of glamorized that life. And the dichotomy of those two speeches, I thought was interesting. But I thought that Bogle had locked into something. And after seeing what happened in the 60s with his betrayal of his own company, he was just determined to never leave that one tunnel vision idea. But it's in the 80s, people were having fun and like doing cocaine, and riding in limos.

And then the 90s, there's a whole different kind of atmosphere, and every single speech, there's a book of his speeches. I mean, it's almost so consistent and I found that interesting as well. I lived through those cultures, and I remember how different things were and markets swoon and they crash and even after the crash in the 87, his speech sounded the same. And so I think it was that rinse and repeat for 30-40 years, and I think that also built up trust. So, when everybody else got cheap, people were like, okay, I'm glad you're cheap. But Vanguard had really branded itself as the cheap company because they've been doing it for so long. But I mean, look, the book isn't like -- I opened the book with saying, look, this guy was savage towards just about everybody, including my livelihood, ETFs. I mean, have a whole chapter with Bogle versus ETFs.

And so no matter what you do in the investment industry, Bogle could be tough, but he was pretty friendly with the people. Like, he's good friends with Cliff Asness. He was good friends with plenty of -- Ted Aronson is one of his best friends and that's an active manager. And his son, John Bogle Jr. is an active manager. So, I think Bogle was pretty over the top, sometimes vocally, and to everything and again, unless you're the Puritan, I think you're going to -- there's times in this book, where you're like, he kind of trashes your subject matter, but I tried to get the other side too. I try to balance it out with, you know, this is something -- because sometimes they'll trash things that he spearheaded and he just ...

**Mike:** 00:15:00

Good for him.

**Eric:** 00:15:01

Yeah. I know. Well, there's a whole chapter called "Bogle versus Vanguard" because he fought with his own company constantly, especially after he left. I mean, the whole -- I found a lot of the conflict. And look, I interviewed him for three different occasions, four hours of audio in the five years before he died. So, my goal of this book was to not let that audio die in the dictaphone. But

rather take it, put it on the paper, get other people to comment, make a pseudo-documentary, and offer -- and basically put some of my own analysis in numbers. Because we track the industry constantly. And we're just blown away at the ripple effect of not index funds, but the mutual ownership structure. And that's really the thesis of the book. Index funds would have happened with or without Bogle, but they'd have 5% of the assets they do today. It's the mutual ownership structure, that's the real change agent. And the thing is, it doesn't stop in index funds. It's getting into the advisory business now. It could get into private equity, could get into crypto. That concept is powerful. And I was also interested that nobody copied it in 50 years. And then ...

**Mike:** 00:16:07

Is there a reason why they can't copy it?

**Eric:** 00:16:11

No. Your question on the copyright is more ...

**Mike:** 00:16:13

Yeah, I'm confused. I want clarification.

**Eric:** 00:16:16

The question of the copyright is about the ETF being a share class of the mutual fund. That is a special deal they have, so like VOO is part of the mutual fund. That is expiring, I think in two years. And so that will probably help some other issuers who were thinking of getting into the ETF business, because that helps you to sort of manage taxes in your other mutual funds. I think that would help people. But no, the mutual ownership structure, unless I'm missing something, I believe anybody could do this anytime. Insurance industry has some of these structures. It was just rare in the asset management industry, which is part of the reason I was interested in the book. I was like, why haven't nobody copied it? And then people were like, well, no one wants to drive a Volvo and like, turn over all their future profits if there's no economic incentive to do it. So, I'm like, well, why did this guy do it? And so that's just an interesting expiration...

**Mike:** 00:17:10

It's a real emergent phenomenon, based on several circumstances that were absolutely unique, and personalities that were absolutely unique that set in motion a series of events, right? Now, your mutual fund unit holders own the firm, so of course, they're going to roll down profits. But what an incredible sort of germination of this weird set of circumstances that it's chaos manifesting in something good.

Bogle – the Man

Who Knows Jack Bogle?

**Richard:** 00:17:39

And I want to pull on that thread a little bit that Eric was mentioning about his personality, right? Because it seems like you were able to interview pretty much anybody that you wanted. Was there anybody that you weren't able to talk to about Jack? And I want to kind of couch this with -- I'm trying to understand

what kind of man he was. You've told a couple of anecdotes that paint a pretty complex picture like a bit of contradiction in his personality. So, I wonder if you might first comment on some of the people that you weren't able to speak to, and then kind of painting a broader picture of the man before we dive into the business model.

- Eric:** **00:18:16** Sure. Two people that stick out that -- well, some of the people I was able to interview include Warren Buffett. I mean, he returned my email within a day. And I was like wow. And Bloomberg, I got the email from Bloomberg TV people who have it on file and they were like, he won't get back to you. And by the way, we're only doing this as a favor. Don't bother him. But he got back quickly. He genuinely likes the guy. And then I got Michael Lewis, Cliff Asness, a variety of people. Jason Zweig, I thought was one of the best interviews. Jason had been covering him for a while and Jason is very articulate and has been really eagle-eye focused in the fund industry for a long time. And I got some of the people who worked with him back in the day. Jan Tordosky was with him in the room when they decided to do the index fund, as was Jim Rippy. And then some people who worked at Vanguard; Gus Sauter, Jim Norris. Gus was crucial. Gus is the guy ... ETFs had to deal with Bogle's wrath and Gus also threads together this -- there was Bogle and then Jack Brennan and then Buckley McNabb and Bogle didn't have the greatest relationship with Brennan, but Gus did have a relationship with both of them and there was some hurt feelings there and some conflict, but I think Gus was probably the perfect guy. Some people who I didn't interview included -- I tried to get Kramer to interview. I was just curious with Kramer would think of Bogle. He didn't reply. I'm glad. Now I feel very happy trashing him on Twitter for how he's completely wrong on every single call. It's amazing. He has a reverse Midas touch. Yeah. dude, you guys are factor guys. I would put this into the factor zoo and vet it and see if the academics ... find something. Yeah.
- Rodrigo:** **00:19:57** We'd machine learn the crap out of that. It's one of our indicators. It's literally how we got our alpha in 2022.
- Richard:** **00:20:04** We even have vacation indicators here, so. Yeah, we have a lot of....
- Rodrigo:** **00:20:10** It is amazing.
- Eric:** **00:20:12** It really is. Another person who, they wouldn't interview is the heads of Vanguard like the top executives. They politely declined. I think they're trying to shift away from the Bogle name a little bit. I understand that. They've largely been nice to me. And also, I worked with their PR guy, Freddy Martino, who was very good with the data. There's a lot of data I had to really get straight here. This book's written casually, but hopefully there's enough data for the nerds to get something out of it as well. Or flip, I hope there's not too much data where

the regular people are like, oh this is too intense for me, I don't know. But they were very helpful with that.

So, Vanguard helped me, but they didn't offer anybody, they passed. They have a new PR, head of PR there, who I believe used to work at Janus. And I think they're just feeling a little attacked lately by people with ESG. And like, oh, plastic's going to ruin the earth. And I think they're just a little more cautious with who and what they do. Plus, they're probably trying to shift away from the Bogle name a bit. I mean, they got rid of the ship logo. So, I have a chapter where I look at some of the ways Vanguard is sort of forging its own path. Yeah.

**Rodrigo:** 00:21:21 So, I've always thought that the reason or the uniqueness about Bogle and Vanguard was, they were the personification of compound return, right? Where you have this very long period of flatness, flatness, flatness, it looks flat, if you look at the growth of that company, right? And all of a sudden, in the last chapter of the book, it just goes hyperbolic. And I always allotted that to his personality and the fact that he was consistent from day one. But you're telling me that he wasn't as consistent. So, would you say that he was consistent messaging? I'm trying to understand that? Was his message consistent from day one? Or did he flip flop a lot and kind of go with the flow?

**Eric:** 00:22:03 Well, once he locked into the Vanguard mutual ownership structure, I think ...

**Rodrigo:** 00:22:08 And that was in ... 73?

**Eric:** 00:22:11 74. Yeah, 74-75. And then once he found out about the index fund, he read the Journal of Indexing. I will say this guy got a lot of benefit from flipping through financial magazines and journals. So, I say in the book, it's a really good habit. Because I wrote a book on the ETF and they got the idea by flipping through this boring SEC post-mortem on the 87 crash. It was on like page 300. So, there are definitely diamonds in the sort of academic deep reads. You know, everybody's on Twitter and I think that it's a good lesson that some of the really good stuff's deeper in the haystack there. But anyway, by the way, your stat is so true. Listen to this data, Vanguard has 8.3 trillion. 7.3 trillion came after the firm's 30th birthday. So, it took the firm 30 years to get to one trillion. And then, what are we at, 15 years to get to eight.

And the other thing that's interesting about Vanguard and I think, it's probably a scary chart if you're a big asset manager. I really think the small asset managers are probably somewhat immune from the Vanguard effects. They're going to serve local audiences, they're going to serve more sophisticated audiences, they're going to have relationships. It's that big ... company that I think are going to be really under pressure for the next 30 years because Vanguard has 30% market share of assets in US fund business, but only takes in 5% of the revenue. I mean, I don't know a spread that big ... that they ...



- Rodrigo:** 00:23:46 Yeah. I saw that stack and I could not believe it. Like, that is out -- you've never seen that in Wall Street and you never expected to see it, right? Like, not ever.
- Richard:** 00:23:56 And Bogle's personal stat, the fact that he -- I mean, as compared to and proportion to the AUM that he managed versus any other company in Wall Street, like the wealth that he accumulated was much, much smaller than any other major fund manager.
- Mike:** 00:24:12 And I think you make a great point, Eric too, that at size, at size, how are you going to add alpha when 30% of the flows are Vanguard, right? The stock-to-flow idea of Vanguard sitting on a huge piece of what the index is, money's flowing in which reinforces that, and then you at size with billions of dollars are going to try to add value in some way. Now, I think cross asset might be a way to do it. I think there are some ways because you do get locked in certain indices. Like, you draw the bright lines around the S&P 500, draw the bright lines around the other major indices, hard to beat. When you start to open it up a little bit more and you get sort of cross asset or cross exchange type stuff, maybe, maybe there's a chance, but at size it's hard.
- Eric:** 00:25:04 We had Rodrigo on about the 60/40 stacking thing, that's a solution. I mean, I think if you have a solution, or if you're operating where Vanguard isn't, this is why I've been so defensive of Cathie, not because I think her returns are going to go up or down. But she has a lane that Vanguard doesn't swim in. So does crypto. So, anything that's like crazy wild, and high active, I think is going to have a home, believe it or not. Because I think the more serious investors with the CFAs are going like, well, we're going to own mostly FAANG and then we'll make stuff at the edges. The problem there is, you can now get -- there's many versions of a Vanguard Growth Fund for six basis points, which hold mostly FAANG, a little less FAANG, S&P. I mean, there's really -- I mean you got to be real out there to be different at this point.
- Otherwise, if someone looked at your holdings and you go well, I can get mostly the same thing for four or five basis points. I mean, that's why and that's what the big shops sell. But the problem is they can't go full Cathie Wood because they have people use funds ... . So, they can't just switch and go high octane, because then if the boomer who owns it, they don't want to have that much risk. So, they're locked into closet indexing for a while, and that's where Vanguard is eating their lunch, because people are like, why would I want -- I just buy, as Ben Carlson said, people moving from closet indexing to just indexing. That has been the main shift here. Yeah.
- Mike:** 00:26:28 Beta's free, essentially, access to beta in specific markets is kind of free. You have to want something different like something with high active shares ...

**Eric:** **00:26:37** Yeah, or price it like beta, like Goldman's GSLC is very much like the S&P, but with a little tiny factoring. It's closet factoring, I guess, or whatever. But closet indexing factors style, but it charges nine bips. So, if you are going to, I think you have to just price beta at beta and then have your ... be appropriately based, which is why I think ARK and ... get away for 60-70 basis points. So, I also think alts probably have a bright future, because this has been a long, nice run for the 60/40. So, I think alternatives are in a good spot, to be honest. And Vanguard, isn't really ...

**Rodrigo:** **00:27:14** I agree. And it's so funny that you mentioned the 1960s as being a period of growth. I was planning on going back to the last 100 years to see which periods added to grow stocks becoming highly concentrated and grabbing all the money. My thesis is that in periods of benign inflation, where you have visibility of funding, whether it's you have a 30-year project, which is what growth stocks do, right? They'll say, listen, I have this crazy idea, it's 30 years out, but the inflation's super controlled, volatility of inflation is low, there's visibility for a future. And they would just gather all of the money. You concentrate all of the flows available to those five, six, 10 companies that are really doing something novel and innovative, with this massive duration.

And the moment that you start seeing inflation peak its head, it starts breaking things, right? You all of a sudden, go from a very visible handful of stocks, where everybody agrees are the winners, to oh my god, these guys are down 50%. We have to allocate money elsewhere. Emerging markets are becoming useful because of inflation and commodities, you start seeing value stocks, with tangible assets in their books where you can actually, when you're buying the company, you know what you're getting, so on and so forth. All of a sudden, we go from one bet, one massive bet to 20 dispersive bets that active management will benefit from. So, it will be interesting for me to see because this is what I think has happened, right? I think we are going to be in a period of inflation volatility that is already breaking things. And active management is going to be back in vogue in a way that it was 2000, in 2010, maybe. When did inflation begin Mike, in and 67-68? When was it like -- I think it was around there ...

**Mike:** **00:29:07** It was -- actually, inflation volatility was pervasive postwar. It was pervasive through the 60s and 70s.

**Rodrigo:** **00:29:13**  
But it was that ... period in the 60s was a little bit ...

### In the Long Run, Reality Rules

**Eric:** **00:29:16** It got crazy in the 70s, right? Yeah, I have to look but I know the market went down and ...

**Mike:** 00:29:22 Postwar, what happened was we had massive inflation spikes, and we had the Fed keep rates very low. In the 70s, what happened is we had massive inflation spikes where the Fed actually interjected and raised rates to close the gap, which creates very different impacts to this system, the financial system. But anyway, that's just a small point of clarification. It really doesn't matter. They do wreak some havoc with some equities and you have to think about what your starting valuations are as well.

**Eric:** 00:29:56 He has a quote, "*In the long run, reality rules*". I think that's sort of what you're talking about. Like, he has a whole chapter in his last book where he looks at the shooting star funds, including the Genus 20. He probably would have put ARK in there if he was still alive and he wrote it today. But two things there. I think one is a lot of people, and this is where I defend ARK was, a lot of people will be like, well, I agree with you. People are going to go back to stuff that has tangible value, cash flow, dividends, like the stuff that matters, right investment returns. Speculator, speculative returns just crash, right. And I think -- I mean, that he actually marketed over and over. He just sort of made it to like, that's why just own the whole market. And so I think a lot of people bought into that, buy the whole market. And then they want something that is completely speculative just in case that lottery ticket comes up. They put that on top like hot sauce.

So, when you say active, the active I think that's going to have a problem coming back is like the Fidelity Magellan Active. I just, I don't see a home for that. In fact, they put an ETF out, it's got like 80 million. I mean, it's a total flop. And that was the biggest fund since sliced bread. In fact, Fidelity is who Vanguard replaced in market share at 14%. Now they have 30. But Fidelity was the last high watermark in the industry. And remember, if you -- I don't know if you're old enough, but Fidelity ruled. I mean, like they would mock index funds. They didn't think this would last. Americans don't want average. I think over time, he just won the hearts and minds.

Also some corrections, some SPIVA data, I think all that just added up. And I think I have a chapter in the book called *The Art of Doing Nothing*. Because if you notice, when there's a sell off, like this year, Vanguard's taken in 30, sorry, 55 billion. The rest of the industry has seen 30 billion in outflows, like everybody else combined, that includes ETFs. And we're going to see this over and over. And the reason is, I think it's not because this behavioral literature came out, it's probably a little of that, and I do give it credit in the book a little bit. I think the index fund cured the behavior problem, because people were finally like, oh, I'm going to own the market for three bips. I cannot do better than this. And they're like, okay, fine, I'm down. But what am I going to do? Am I going to switch out of this, chase something, and then go back to this when I -- Ah, screw it.

So, I think they've come to this settlement and maybe something will change that, I don't know. But I think they've come to this place where they just think I cannot do better than this fund. And that's why you never see outflows from their funds, in particular, during sell offs. And that's why these big/long advisors have come up, the advisors who are like *do good behavior*. I think it's a lot easier to do good behavior if you're in a cheap index fund. It was harder to do behavior in the 90s, when you had a mutual fund that was underperforming. You're like, well, do I keep it or do I switch out? Let's switch it, go to the next big manager that's doing well. So, I would just say, if I'm active, I would just plan on the core of being occupied by cheap beta funds, and figure out how to add to that, or offset it if there's a sell off. That's why that stacking concept, like I said, I thought it was pretty powerful, because you can have your cake and eat it too. Because as you guys said, nobody really wants to give up that 60-40 at four basis points. It's almost -- it's like trying to give up Amazon. It's just too good, the value ...

- Rodrigo:** 00:33:27 To attractive, too cheap, too -- Yeah, all of that.
- Mike:** 00:33:29 Here's the macro -- Well, go ahead, Richard. Maybe you're going to say what I'm gonna say...
- Richard:** 00:33:36 There's an argument to be made that one of the reasons why it was so easy to stick to is that there was maybe an element of self-fulfilling prophecy attached to this, but we were in the mother of all bull markets for the US 60/40 and for owning beta. Could you see a scenario in the next few years, if indeed, inflation volatility is coming into the zeitgeist and sort of pervasive across most countries that the market beta starts to suffer enough and passive maybe has an inflection point? Could you see a scenario where Vanguard starts to lose its dominance in the market because of inflationary dynamics?
- Eric:** 00:34:20 I would say 95% no. I don't want to be absolute. But two things on that. One, ... your question on this has been a great market for beta, it has. But Vanguard took in money every month in 2008. We could all agree that was not a good year for beta. I mean, I'm telling you, these people are like Navy SEALs. They are so dedicated and resigned to this being the way. To your other point, passive just isn't big caps. Vanguard has the Small Cap Value Fund, VBR. So, there are actually cheap passive ways to sort of maybe move around a little bit, make a couple tilts and whatnot. Again, though, Vanguard doesn't do private equity. Well, I think they might, but they only have a partnership. They don't do Cathie Woods style ARK, they don't do themes. That's why I think you see those lanes actually lasting despite perhaps their lack of research due diligence that people are like why would you buy a cybersecurity ETF? You probably distill it down probably getting like, I don't know, 80% growth, a little momentum. Like, you could probably just break it down, what you're getting. And yet, it's got this nice, cute name and I think that's why.

But people sometimes after -- I have to remind them, ETFs, especially ETFs track things that help you hedge. Although, well, I'm usually saying that for ETFs because there are more alternative ETFs, you've got gold, you got inverse. With Vanguard, I think, yes, there's somewhere people might look for something to hedge or offset. I just don't think they're going to leave. Again, I think they're resigned to this being the best deal in town. The only other thing that I could see happening, and this is, I still think I'm bearish. Look, I'm bearish on anything trying to dislodge three basis point beta, I just am. But direct indexing has come along and said, hey, we'll let you pick what you want. And that's one way maybe, that you could find some shift, but now Vanguard's offering direct indexing and will probably do it at a very low fee. I think Bogle would be against that. He would be like, you'll probably end up underperforming. All of a sudden you're the active manager, you don't have any research skills, just stick to the total market. And I would say Bogle was so purist. He didn't even like international, he would just buy VTI and maybe some bonds and that was it.

- Mike:**                    **00:36:54**                    So, this is the challenge though. So, what is the balance of Vanguard's assets? Do Vanguard's assets mimic the global market capitalization of the global market portfolio? I will bet they do not. I will bet they massively overweight US equities in AUM sets there. Which is plain and simple. This is return chasing. This is reinforced by the behavioral side of the fact that every time it's gone down, it's come back up quickly. We have been faced by several bear markets that lasted two to three years. We have not had a 10 to 15 year period where we have negative real rates of return on stocks and bonds. Let's get to the 14th year of negative real rates of returns like we did in 1929 to 1945. And like we did in 1967 and 1982. Let's get there to test the mettle of these Vanguard disciples. And that's where you can tell me that they got the mettle.
- Eric:**                    **00:37:57**                    Yeah. I mean, that is such a long period and an extreme period. But some people would be like when I was talking about HYG, they'd be like, well, what if X, Y, and Z and I'm like, you're describing World War Three. Okay. If World War Three happens, I think we have bigger issues than HYG's discount. But like, I think -- I agree. Like I'm always leaving open room for change, room for a psychological shift in how people think of things. I guess my question - Bogle would probably say this, though. He'd probably say, look, in fact, he was pretty bearish in his forecasting of equity returns going forward. He said they're only going to return 5-6%. And this was like, five years ago. They've demolished that.
- Rodrigo:**                **00:38:41**                    Well, he did it over a 15 year horizon, though, right. So, we're only a third of the way through.
- Eric:**                    **00:38:45**                    Exactly. He probably ... yeah, there's nothing -- he would agree with you. I think that we owe a lot still. But he would still say, what are you going to do that's better than buying companies where people wake up every day, go create value

and has cash flow? I mean, commodities, they don't have that. Like, that's really what he honed in on, is the investment returns of companies. Yeah.

**Mike:** **00:39:08** Yeah, which is a great. It really is a function of when you make a bet, and by bet, I mean you decide that you're going to buy the American companies. That is a very significant bet. Right? That is only half the market cap and only represents maybe a quarter of the global GDP in the world. So, it's a massive overweighting. So, is that being driven by this passive exposure? Hell no. That's being driven by because my neighbor owns it and he's doing great and I've sold all my gold, I've sold all my international, I've sold all my emerging markets. How do you think we get here? How do you think we suck all those future returns today? By getting all the baby boomers and all the millennials all the Xers, long US stocks with 3% of the S&P being ...

#### Indexing, or Not

**"Rodrigo:** **00:39:57** Which US stocks too, right? Again, growth.

**Eric:** **00:39:59** So, I would -- First of all, he would say, well, US companies get, I don't know, something like 40% of their revenue overseas, you've got exposure there. That's sort of one of his push backs. Also, I would say most people don't agree with him. In fact, I couldn't find anybody who agreed with his international except for Taylor Larimore, who's the *King of the Bogleheads*. He said he actually turned out to be right on that, although it's not over. You're right. It's just past 10 years. But like Rick Ferry, I don't know if I asked Rick Ferry about international. But Christine Benz, he was like, I disagree with him on that. I talked to Dan Egan of Betterment, I had a great quote. He's like, look, "*Rome fell*". So, I want to own, you know, he was like, I'm actually taking Bogle's concept, but to the whole world. And so he's -- I don't know what. So, that was probably the best counter is that other empires have fallen and I get that. So, I think that's a fair argument. I think the gold one is not bad, either. Because gold has a very useful property, has zero correlation. It really is a special asset, in my opinion.

**Mike:** **00:41:04** And it was trading, it was trading 5,000 years ago. Let's get through all the companies in the S&P 500 that were trading 5,000 years ago, shall we? Let's just list them now.

**Eric:** **00:41:13** Well, he would counter with that.

**Rodrigo:** **00:41:16** I'm a millennial. Hasn't Apple been around for 500 years?

**Eric:** **00:41:22** Well, you know that the counter to that is that and I try to remind people in this book is that, this is why -- all this isn't really about indexing. The index is an active organism. It's always evolving, it's kicking out the shit and adding in the good stuff. You know, somebody wrote a column, something about like Tesla can relax

now it's in the S&P Well, not really. Macy's just got kicked out. Companies get kicked out. If active doesn't like you, you're going to get -- your price is going to get lower and then the indexes are going to sort of pile on, because they're going to kick you out, you get lower weightings. But active controls that dynamic. But the indexes are just sort of going to like, they're almost like those things on the side of a shark. They're going to just follow where things are and sort of feed off of it. They are riding the coattails of active, I admit that in the book. It's true. The question is how active do you need to make those coattails make sense? And that's a debate and I put different viewpoints in the book on that. Some people say you only need like 5% active, some people say you need 50.

- Mike:** 00:42:23 How did they come to that? I mean, obviously, things are priced at the margin, right? Everything's priced at the margin for the final user, whether it's commodities, or stocks or borrowing money for your mortgage. At the end of the day, the marginal user prices it for everybody in the stack. So, how did they come to that conclusion? Did you get into any of the reasoning behind it? Because it's fascinating to me. I wouldn't even know how to tackle that problem.
- Eric:** 00:42:49 Hold on, give me a second. I just got to look it up in the book. But the -- Let me do a search here for Control F.- Burt Malkiel. Yeah ...
- Mike:** 00:43:01 Yeah. Good old Burton. You're going to get me fired up now. Fucking ... bullshit.
- Eric:** 00:43:06 Let's see what he says here. He had a quote on this that was like, probably -- okay, here we go. I wouldn't worry if 95% of the market was index funds. There will always be somebody to ensure the market is efficient. Here's Gus Sauter: I don't think I don't have any worries about it. Will market efficiency be compromised, I don't think -- if it's 80% and there are any active managers left standing, and they find a cheap stock, they're going to buy it. And if it gets expensive, they're going to sell it. So, I don't think market efficiency is challenged by the growth of indexing. And then I had people who were 75%. Bogle actually was quoted saying, if everybody went to index funds, there would be chaos. But then that's the quote people use who are trying to make the case. But then he followed by saying *that will never happen*.
- Rodrigo:** 00:43:52 Well, it just doesn't make -- you got to take it to a point of extremes that just doesn't make sense when you think about it rationally, right? There's going to be a point where if the vast majority of the industry is indexing, and the indexer is going to get out of a stock at a certain time, get into other stocks, then they're going to be front run to a point where active management will become more and more active until that's ..., right? This equilibrium of this active market will always be -- will always get to a point -- clearly 30%, I never expected to be the case, right. But here they are.

- Richard:** 00:44:31 And that could be peeking because I think we're ignoring the demographic component to all of this. Yeah, there's a point at which there's going to be net outflows from the boomers, they're going to start to live off these portfolios. And these glide paths and these automated allegations to passive have, I think, created this self-fulfilling prophecy nature to passive. But at one point, we will arrive at a tipping point after which we will start to see some outflows. And I guess my question to you is, how aware do you think Bogle was with regards to this generational demographic component? And how aware was he with regards to regime dependency? I mean, there's an obvious regime, tailwind that beta has benefited from that might not be there in the coming years.
- Eric:** 00:45:24 Yeah. No, I mean, his worry with passive was they would own too much of like - they have too much control over stock voting. He wasn't too worried about that. I think part of it is, again, that indexes are active. The S&P is literally run by a human committee. It uses some fundamental screening stocks. You've got the Russell 1,000, which is maybe a little more beta pure. But then you've got like, stuff, that's -- brands of indexes that rebalance on different times. You've got mid-caps, total market, small caps. Really, there is no such thing as passive. Everything's a bet on something. But you're right, the target date funds largely hold US large caps. And possibly the -- like Mike said, I mean, I think between 2,000 to 2009, the S&P was down for the whole decade, and it severely underperformed small cap value. My point on that was, I think we might find the beta investor or the big long advisor might add a little DBR. So, that's the problem is some of the stuff that might work like small cap value has clearly got room to run; international small cap value in particular, you can probably get that under 20 bips.
- Rodrigo:** 00:46:31 Right. You go from one Vanguard fund to another, one style, to another within the Vanguard family. Yeah.
- Eric:** 00:46:36 Yes, a lot of alpha has turned into beta, and then gotten cheap ... the mutual interest of structure. So, I think part of it is, adding value added beyond that process. And so I don't disagree. And I will say on the generational thing, (A), boomers are going to live longer than we think, by the way. That's why biotech's such a great buy. They want to live forever. They have all the money, and they want to live forever. So, they'll be around for a while. I do think when they start withdrawing, they're largely going to sell their active funds. I think they have less loyalty to those funds, they're probably put in there by a broker. That's where I disagree with someone like Mike Green. I think it's the active funds that are going to be -- have a mass withdrawal. That's what we've seen.
- By the way, in 2020, in March, active mutual funds saw 300, I think it might have been 400 billion come out in the month. That's almost half a trillion. I might be overstating it, but let's just say three to 400 or 500 billion somewhere in there.



That's ridiculous. And that, and so we -- we wrote a note saying that they're going to see over a trillion dollars in outflows this year. So, you're going to see that first, that's going to be the first problem. And then in the next generation, maybe 20 years later, it's possible passives start selling. The question is, what will be the next bid what will buy under that? Maybe nothing. So, maybe in 20 years, the stock market has like, it's just, the bottom falls out. There's a huge 15 year bear market and people just ditch equities all together for a long time. And there's some new paradigm or crypto -- I don't know. I mean, it's hard to predict all this. But I will say I will back the cash flows.

**Mike:**                   **00:48:09**                   Well, no, I think you make some good points. And I think, Rodrigo, tying this back to regimes I think is key. Money goes to where it's treated best. In 1980, the S&P 500 had a 29% exposure to oil and gas. 1980 happens to be the end of the 70s. What did well in the 70s? Well, oil and gas did really, really well, Yom Kippur war and whatnot. And then it took a nosedive till the tech bubble, where it came in at three to 4%. Then we had the 08 rip back up to 18%. Exxon's the largest company in the S&P 500, and now we're back at 4% again. So, if you think there's a regime shift occurring, and you think there's inflationary volatility, which is a call, this is something that you're saying, you can do it by adding small caps, adding those resources, adding international. There's lots of stuff you can do, but now we're in the realm of active, right?

**Rodrigo:**               **00:49:10**                   The point is that you can go into the Vanguard family and get it for 20 bips, right?

**Mike:**                   **00:49:14**                   Sure. But you're still making some active calls here. You're still making some active calls. And my point is, money goes where it's treated best. So, if we have an inflationary surge right now, and if we are going to see oil prices become bullish for a decade or two, which has happened in the past, because of the supply constraints, because of all the stuff going on, because there's no investment in ESG, in any of the production. If we have that going on, in the S&P, you have a grand total of a 4% weighting right now for your energy exposure. If the regime has shifted, your S&P exposure is off the reservation. It's not balanced in way shape or form. And it happened in 2000, it happened in 2008, it's happening again. So, it's just something people have to be aware of in a market cap weighted system. If you're investing for 100 years, then you probably don't care. Anyway, I turn it back over to you guys.

**Eric:**                   **00:50:11**                   Let me bring up one point, and I think there's something we saw with VX-US. This is the Vanguard International Fund. It has taken in, I think, money every day or week for like three or four years. And we were scratching our heads because it didn't have a great run. It wasn't -- I think you do have Vanguard investors and the big long advisors, rebalancing. So, I do think that they have moved into international over the years, because these flows don't really make performance chasing sense. But they're very thick and they're very consistent. So, I think

there's some of that. I guess the question is, is there -- will something happen where everything inside the Vanguard family, you can't -- like, there's nothing that is up, because a lot of stuff has just gone up for a long time. And that's something again, back to that 60/40, the 60 and the 40 has gone up.

And if rising rates mean all the bonds people own are worth less, which is I really worry about bond mutual funds. I feel they keep seeing outflows and there could be a nasty downward spiral coming up. And if high rates and inflate -- let's say you're raising rates and the inflation is high, that's bad for stocks. Then you're outside of the 60/40. Vanguard doesn't play in too many places, maybe small cap value, maybe international, I guess. But I think international takes a hit if the US does. I don't know. I think things that are structured in a way that can maybe sort of offset some of those 60/40 declines I think we'll do good. That's why that like Bruce Bond and the *Innovator Shares*, uses flex options to sort of lock in a certain downside, or like give you a place between say five and 20%. I think those ... Yeah.

- Rodrigo:** 00:51:56 That's it. So, I think your prediction was in the next five, did you say five to 10 years active continues - sorry, passive continues to eat active funds' lunch, right? And then maybe afterwards, something else happens.
- Eric:** 00:52:13 Depends on the active. But legacy traditional, legacy closet -index-ish...
- Mike:** 00:52:18 Closet indexing ...
- Rodrigo:** 00:52:21 Yes, because my view is because I was going to, given that we're going to live forever, Eric, I was going to bet a penny that by the end of this decade, I'm actually like, at high active share active management, not closet-indexers, are likely to be getting more flows to the category than passive. That's my prediction. Like, year nine ... Yeah. Like, ... generally active managers that have a large tracking error to the index, will be a category that is going to dominate and ...
- Eric:** 00:52:55 Totally. Oh, no.
- Richard:** 00:52:57 That's an implicit call that this index is going to suffer.
- Eric:** 00:52:59 Well, no, I think -- So, I agree with you. We are bullish on two things, dirt cheap and shiny objects. And shiny objects, it's my -- or hot sauce. It's my term for high tracking error, which would be the academic way to say that. I still think dirt cheap muscles through, because the value proposition's so strong, it's like Amazon. I think what happens is people use the shiny object lane to (A), buy things that are like call options. Major asymmetric return possibilities, crypto, ARK, and things that can possibly offset or hedge against that 60/40. So, I think both grow. The middle's screwed. That's my thesis.

- Rodrigo:** 00:53:41 Yeah, yeah. No, that's actually a very good point. I agree. All that legacy closet-indexing when you're actually 99% the same as Vanguard and 1% active because you got -- also, they got too big to really be active and have too high of an active share. That's the middle that I agree will go away, right? You're either going to be adding value, or choose that you can't, and go passive. And that middle is going to squeeze down.
- Eric:** 00:54:09 Sorry, go ahead.
- Richard:** 00:54:11 No, you go ahead.
- Eric:** 00:54:12 Okay. So, just on that concept, I have a chapter in the book called *The Fall and Rise of Active*, and that's exactly what it's about. And the fall, by the way, I say, look, everybody thinks it's underperformance, SPIVA reports and all this and I'm like, partially. But that's just a symptom of a real root problem, which is that, dollar fees. And this is something I try to explain. It's hard though. If you charge 1%, you're small, it's completely justified. I mean, your total dollar fees aren't going to be that much. But some of these companies got to be \$100, 300 trillion companies. And they never passed on any of those economies of scale, especially given the market gives them 9% a year of freeness. That's a lot of gravy. All they had to do was just share a little of that with the customer. And I think they would have built up trust, their performance ratings would have been better, because they would have been, at this point, maybe -- they would have been four basis points.
- But possibly, if they had a schedule of passing on economies of scale, they might be at 35. And their ... would have been much higher, not as low as they are in the SPIVA report. So, I sort of find it ironic that the companies that were designed to analyze stocks, and they're probably companies that would sell a stock that didn't recognize these disruptive periods, they themselves missed an opportunity to bypass this major disruption. So, I think that's the sort of original sin. Underperformance came after because now you're at 70 basis points and then your trading 80% turnover. So, you're like 150-170% in costs. And then the S&P is here. You have a lot to catch up to just to get to start. And now that you can buy the starting line. Let's just -- it's very easy. And then you take that 170, and you put \$10,000 growth and it becomes a \$200,000 gap in 50 years. It's just very compelling. Had they had they shared I think they could have made Vanguard a much smaller company.
- Mike:** 00:56:18 It's hard for Blockbuster to see Netflix.
- Eric:** 00:56:21 I agree. And I admit in the book. If I was a big mutual fund company, and all this money came in, I would have put our name on stadiums too. I would have hired more people. I would not have shared any. I know myself. So, ...

- Rodrigo:** 00:56:35 It's anti-capitalist. Isn't that like almost communist? That's so anti-American.
- Eric:** 00:56:40 Well, I will say Barry Ritholtz has this quote about Apple and how Steve Jobs would put the iPod out, then he would put one with more memory but at a cheaper cost. And he kept putting more memory, cheaper cost, and that's how Apple blew away everyone in that Steve Jobs come back era. So, there are other businesses. And Steve Jobs even says you got to cannibalize yourself before somebody else does. So, there is a classic business study here for people, I hope, in that you got to make sure you're taking care of your customers, don't get too greedy. There's plenty of money still left over. And it's fine to charge for high percentage fees if you're small. But again, once you grow, the dollar fees become absolutely ridiculous.
- Rodrigo:** 00:57:23 You got to find the right balance because it's funny it's easy to reduce your fees, but not easy to increase them, right? So, you can go to a period where you're growing, you're growing, you're growing, like I'm going to share some stuff, I'm going to reduce my fees on a schedule here as I grow from -- my dollar fees are growing. But what happens if there's a disruption, and your AUM gets cut by a third? Are you going to then increase pro rata your fees back to where you were at the previous two thirds AUM? That's the way to do it and that's a way to -- if you're thinking about the shareholders of the company, they're saying, well, this isn't just a one way road up, right? Maybe there's a way to find -- to adjust fees, increase them as your AUM goes down if you have a bad year. But it's ...
- Mike:** 00:58:05 I would add to that one other component. When you've commoditized something, the value of a commodity is the lowest cost producer. If you're a manager who provides value, actual value, like RenTec is not reducing the five and 50 on their fund, and they're not letting you in to get it. And they're going to give you two birds as you should reduce fees and share it with the investors. No, that's not happening. That is not happening. Right? So, this is a conversation also about value. If you're providing value to the investor in excess of the fees, then I mean, it's a slightly different fee discussion.
- What Vanguard did so wonderfully is they commoditized beta, and they trained people about the commodity that is beta, and they change the finish line as you said, Eric. They changed it. They said, this isn't winning, or getting close to this isn't winning. This is the bogey, like this is what you get. So, anyone who's going to charge you a fee above that needs to be on some reliable timeframe having an ability to add beyond the fee they're charging.
- Richard:** 00:59:17 And alpha has become so scarce that it has to command some form of premium, right? At the end of the day, beta has just blown alpha out of the water for the vast majority of managers, which is why it's grown so much. So, if you do have a consistent alpha, it's going to continue to command a premium. I can't see that becoming commoditized.

- Rodrigo:** 00:59:35 Yeah, and I remember two years ago, ...
- Mike:** 00:59:38 The thing too, Richard, is making sure the premium is above the fee, right? We add 2% of value, and we charge two and a half percent fee. Well that's kind of...
- Richard:** 00:59:48 Yeah, size matters.
- Rodrigo:** 00:59:49 There was a quant manager that said, *buck the trend*. I can't remember what -- Two Sigma? I can't remember. But they were like, yeah, it used to be two and 20, it's now two and 30. And it was literally two years ago and I'm like, good for you. I mean, to be able to do that and not lose clients, that's ...
- Eric:** 01:00:09 I was chatting at a conference, and to your point, somebody said that the highest cost hedge funds are the best. And I don't disagree. I think people might pay up for certain things in life, but then they go to Amazon for the bulk of their shit. You know?
- Richard:** 01:00:25 Yeah, I love the analogy. Vanguard is the Amazon. It's customer first, its lowest cost base. It is the Amazon of asset managers for sure.
- Eric:** 01:00:32 Yeah. Or like, you take an Uber mostly, but then every now and then maybe you get a limo or something. There are definitely -- everywhere in our life we sometimes splurge. And I think sometimes you know when it's worth it, and when it isn't. And I think Vanguard just took that middle and maybe like you said, they really took it over. And it's hard to go back. But I agree. But I would say **RenTec is doing something completely different. Vanguard can't do that.** And so we always say, we're like, look, you hate Cathie Wood, but she has shown that you go where the index can't. If you can escape the grasp of the index, you're probably okay, because there's going to always be a demand. And if you're way far away from the index, you also increase the chances of some performance that is unusual or high. And people will pay attention to that.
- I think with the days of like, oh, we beat the S&P by two percentage points, I just don't know if that does it for people, even though there are managers that do it. And you know, the interesting thing about excess return, if you do excess return, I think it was Jeff Ptak at Morningstar put it up and he's got some great data; ARK isn't that great at that. And but we may be in a post-excess return world where people don't care if it's excess or not, it just has to be different. Because and also I think there's a feeling that well, okay, but only two, 1/3 produced any excess return at all, and I don't want to be wrong. I don't want to take a 33% chance for 80 bips and then I'm wrong. **Shit, joke's on me.**
- Rodrigo:** 01:02:12 Conversational Alpha and all that, right.

- Eric:** **01:02:13** Conversational Alpha. Conversational Alpha I know you love that. No, that was one of my favorite past memories. Yeah.
- Richard:** **01:02:21** But you just dropped a good Conversational Alpha that I just took a note of and I'm stealing it. I love this idea of what was it, Amazon -- Vanguard being the Amazon of asset managers. And then what was your last point?
- Eric:** **01:02:39** You don't buy everything from Amazon. I mean, nobody does. Or, going where the index can't.
- Richard:** **01:02:45** Going where the index can't, that's right. That's the one.
- Rodrigo:** **01:02:47** Yes. That's a good one.
- Eric:** **01:02:48** If I was starting up an active shop, I would make sure I had at least some of that. Maybe you don't do -- maybe I don't know. There's a balancing act. If you're young and small, the problem with the legacy managers is they have to be closet indexers now because they have boomers who signed up for a core exposure. So, they're locked into it. So, for the younger ones, that's why ARK is in a good spot. They actually pioneer what I think is a whole new genre that could ultimately, like you said, be bigger than a Fidelity someday, which is high active, just hot sauce. Hot sauce for your boring vanilla, which is very good for you, you know it'll do well, but it's boring as shit. And you want something a little extra. You want to hedge in case it doesn't work for 10 years. I find there's a lot of innovation potential there.
- Rodrigo:** **01:03:36** Speaking of hot sauce, and I want to shift the conversation, I think Vanguard's a great story. Read Eric's book when it comes out. When does it come on?
- Eric:** **01:03:44** April 26. But you can pre-order on Amazon.
- Mike:** **01:03:47** Pre-order now. Pre-order it now. It will be available in all formats; Audible and all that sort of stuff?
- Eric:** **01:03:53** Yes.
- Mike:** **01:03:54** Awesome.
- Eric:** **01:03:55** Yeah. By the way, they gave me two choices for the audio guy. And one of the clips had the guy playing multiple characters. So, I was like that guy. So, hopefully he'll read like Jason's wife's voice differently than like Michael Kitsis. And I don't know, maybe we'll see.
- Mike:** **01:04:12** Yeah, that's awesome.

## ETF Markets Today

- Rodrigo:** 01:04:13 Let's talk about Spicy ETFs and ETNs out there these days. Let's talk about what's going on with the Russian ETF and how do you feel about the ETF market now? Like, where are we?
- Eric:** 01:04:24 Well we had Dave Nadig on our podcast. Russia is completely unique. It hadn't happened since he said Cuba or Iran. You got to go back before the ETF to find anything like this. ETFs have halted creations on occasion, like dipped where it trades on even though the underlying's closed. And ETFs are good at that. They become price discovery vehicles. I mean, every day Japan ETF is open when the underlying is closed and it works like that. No problem. Russia, they halted the trading, the exchange did. That's weird. This never happened. And this is because it's -- the ETF got thrust into a literal governmental geopolitical situation with sanctions. And I don't know, there's really not much you can do. Like, this is I guess, this is why they call them the emerging markets. But those people are probably screwed.
- Rodrigo:** 01:05:09 How does the market maker manage the risk? Like if Japan is closed, there's something ... proxy -- something happening, some sort of liquidity that they can bank on. Even with the liquidity you can get outside of the OTC market for fixed income, there's a reference index there. What's the reference index for Russia right now? What's coming back?
- Eric:** 01:05:35 Well, the market maker's widen their spreads, first of all. But they also -- the price somewhat was determined by investors. I mean, retail started saying actually, it's worth six bucks, not \$1 because of the hope that there's a resolution and it spikes up because it was trading at 33 only four months ago. I kind of get that trade. I feel bad for people who came in with options or bought the ETF itself. I fear that it just gets liquidated, you get nothing for, you know, 40 cents. I'd rather just keep me frozen in there like Ted Williams. And just if it ever gets unfrozen, let me just participate in that spike up.
- Rodrigo:** 01:06:12 You mean figure out what the value is.
- Eric:** 01:06:14 Yes. So, I don't know. It's a fascinating, weird situation and I don't know what to say. I will say ETFs were the last man standing. I mean, mutual funds, halted redemptions, probably two weeks. ETFs lasted -- they did their best. They are like cockroaches. But also, VanEck didn't want to close it, it was the exchange, the exchange says we won't let it trade. So, that's also something to consider. Yeah. Because it is ironic that people are like ETFs are these like liquidity traps. Actually, they're actually liquidity producers. And this situation shows this when the -- even in bonds ETFs, when the underlying is very illiquid, the ETF will trade. You can get out. You may not love the price, but there is a market there, so I like that.

**Rodrigo:** 01:07:07 The market is there. You almost want the mutual fund to use the index as their reference -- the reference index approach.

**Eric:** 01:07:14 Yeah. They don't. And so it seems like the ETFs -- it's complicated, I don't want to get to that whole situation, but like, the RSX would be trading fine if it wasn't for the exchange. And you probably have a lot of whack jobs just going back and forth, whether it's worth \$3 or seven or whatever. It will be fascinating because people will be pricing Russia based on the news flow. I kind of wish it was still trading to be honest, but they won't let it.

**Richard:** 01:07:38 Last time you were here you were very bullish on Thematics in general. You saw this emergence of narrative as a very powerful dynamic in markets and the Thematic ETFs were going to really have their day in the sun. Do you continue to be bullish on that? What are some of the things that you're watching?

**Eric:** 01:07:55 Yes, because again, they're one -- they're out further than Vanguard. They're fishing out further than where Vanguard ... yeah, Vanguard is not going to launch an EV fund. You know what I mean? It's just not their thing. Maybe two or three CEOs down the road, some millennial takes over and says we're doing a cannabis fund, I don't know. Actually, I think they could launch a crypto fund before they launch theme ETFs. And I'll tell you why. The one thing is they have an advisor business and they're going to have a solution for them on public--private equity. And for crypto, and if they don't like any of the crypto pricing out there, they may launch their own. They vehemently denied it to me but let five years go by, possibly they could. So, to answer your question though, themes are bigger than any sector in terms of assets now. They have I want to say, let's see, I'll get to the right number here.

And the reason I'm bullish is because of the narrative, but also because of the idea that -- well, they have high act share. They're able to sort of play into that narrative, people like things they can understand. I think advisors are not crazy about themes. A lot of theme ETFs are bought by retail directly. So, Thematic has 140 billion. Okay, Tech has 160. So, they go back and forth. And then nothing is even close. Those two were just talking about even that's how big themes are. So, we got clean energy. I like uranium. I think uranium is a fascinating theme.

**Rodrigo:** 01:09:31 Mike's ears just perked up.

**Eric:** 01:09:33 The whole thing about themes is you usually get 90 or at least above 80% active share, because they go into small and mids, and you get M&A pop potential. Because a lot of times they'll go to these smaller companies that would never be able to qualify for a Vanguard Index Fund, but they get bought.

So, theme ETFs get this little extra pop sometimes from M&A which you can't predict unless you have illegal information. So, that's why I generally am bullish



on them because they fit into the portfolio. They can complement cheap beta. And even though again it might seem counterintuitive to somebody who is very serious minded as investor, that's why I really am only bullish because of practical purposes. So, cannabis, blockchain, crypto space, work from home, 5G. But the next theme to watch is when they try to repackage value. You know, how you describe things, things you can touch and feel; guaranteed there's going to be an ETF called *Shit you can touch and feel* and it's going to be valuable.

- Rodrigo:** 01:10:33 Tangible in a forward ...
- Mike:** 01:10:36 Shit you can touch and feel, what's the ticker on that? SHIT?
- Eric:** 01:10:39 Yeah. Or shit -- no, no. I got it. *Shit you can't live without?* How about that? Toilet paper, you know. So, because themes really stole a lot of momentum and growth thunder over the past 10 years. And look out, I mean, they started doing value. They did cruises, airlines and hotels, which is essentially a value trade. They could start coming up with creative ways to package dirty energy with I don't know, like... But anyway, I do feel like themes are going to continue to take something working and package it with this cute narrative, and do their best to add active share and say, look, this will make your Vanguard portfolio a lot less dull. So, we have this theme we call *Here we are now, entertain us*, which is the Vanguard riff, which is like I think funds are going to get even more and more silly, entertaining. And if possible, a 10-year Michael Philbrick bear market from hell softens this a lot. But barring that, I think we'll continue to see this.
- Rodrigo:** 01:11:53 Well, no, I think the thesis is that market cap, bear market is a 10 year call. I think Thematic bull markets are likely to be quite interesting.
- Eric:** 01:12:05 Also, because they're a chameleon. They're almost like momentum in a way. Except they're like narrative momentum. They package momentum with narrative
- Richard:** 01:12:13 Well, momentum tends to load -- anything that's working tends to on momentum. So, it might differ on what kind of definition of momentum, what kind of look backs you're looking at, but whatever's working is going to load on some version of trend and momentum.
- Rodrigo:** 01:12:26 So, speaking of momentum, VXX and its upward swing that never quite made it. So, what are your thoughts on that?
- Eric:** 01:12:39 That's a piece of shit. This is what pisses me off because I'm a guy who defends the industry. I think it's a good clean industry, largely. I don't think ... at fault for Russia. No, that's -- Putin is at fault for that. This is on Barclays. I guarantee if some middle manager looked at the books and ETNs show up as debt on an ETN issuer's books, they said, look at all these -- look at this VIX exposure, and we're

going into the Russia situation and the Fed hiking. VIX could go crazy. You know, or they're short VIX. We do not want to be short volatility during this. And they probably just were scared, I guess and they have risk managers and they just said no. And so they just made a, like authoritarian decision. And not once -- there's a guy who used to do Barclays ETNs, who was really great. He went to the ETN conferences, great guy. -- he might have been a guy to push back on this because this is a weird halting of creation. This is a middle manager who gives a shit about the ETF community and the world and the reputation. Whereas I think if that guy was there, he might have said, Listen, let's figure out a way to hedge this or do something. We don't want to damage our own investors like this, or the ETF community. But he's not there anymore. He left two years ago.

So, I think banks should just get out of the ETN business once and for all. There's too many of these willy-nilly halting creation situations. And the problem is people didn't sign up for that. You signed up because it tracked the VIX futures. You didn't sign up because it was a closed-end fund. That wasn't the deal. So, they completely, and it's ... they write the prospectus they can do this, which is -- that's why we have a rating system. We give them all red lights with like 10 different things. And there's some ETNs that are okay. Like, MLP stock ETNs are okay because they're legit. They get around the annoying tax situation when you actually have to hold MLPs and those tend to rarely do this shit. It's usually just stuff that rolls futures, especially the VIX crowd, and I think it sucks.

- Rodrigo:**           **01:14:51**           So, then maybe it's an ETN issue for that particular type of volatile asset class. Because I mean, there must be a value for ETNs given how much use cases -- how many people use it today. What is, steel man, the other side? Why are ETNs good?
- Eric:**               **01:15:09**           Yeah. Mostly they're good. Everything you can get in an ETN you get in an ETF now. The reason they're good is because they have perfect tracking, right, because they just promise the returns ... of tracking. And the number two thing is that they are good on taxes. Like, if you have futures in an ETF, you get taxed as if you hold the futures, which is an unusual taxation. It many times results in a K1 form and generally people just want to get taxed like they owned Microsoft or SPY. With the ETN, you get taxed like that.
- Rodrigo:**           **01:15:41**           Right. So, that's a clear benefit then.
- Eric:**               **01:15:45**           Clear. We actually looked. The percentage of assets in ETNs, in our opinion, are 90% because of the tax loophole. It's not a loophole. It's just a more traditional ...
- Mike:**              **1:15:56**             A tax feature. It's a feature.

- Eric:** **01:15:58** Yeah. So, if you put them in a little ..., they probably die a quick death. But that's why I think they hung around. They used to be put out because they could go places ETFs couldn't yet like India. The first ETN was India. So, they were like, well, India's government's weird, and they put IMP out and it will give you India, and the ETF couldn't. But then everything started to dissolve in terms of countries and access, and now you can get anything physically backed. And so the ETN's only purpose is this sort of tax deal.
- Rodrigo:** **01:16:30** Right. So, that seems to be the major focus in those ETNs on the commodity space in the feature space. Certainly, the higher the volatility, the more likely you are to have extreme events like this happen in the ETN space, right? Well, it surfaces
- Eric:** **01:16:45** Well, it sucks -- This is just when you might want to use VXX. I know I'll probably get creamed by people saying -- people think it's a shit product. There are days, the VIX goes up, it pops. I mean, I used to tell people, the VIX ETPs were largely critic proof. When they get slammed, they get the worst press imaginable. But when they pop, they destroy even a negative 3X equity ETF. Like they'll go up four times more than that. I call it the jackpot. So, nothing goes up like VIX on crazy days. So, there'll always be a market because of that jackpot potential. And that's why they were able to sort of keep an audience even though they're down 9% since launching, is that when they go up, they fucking go up. I mean, it's like ...
- Rodrigo:** **01:17:37** You got to give the masses a gain, man. You got to give the masses a gain.
- Eric:** **01:17:42** It's like triple seven. But yeah, this ruins that whole premise. I just said because now it could do whatever it wants. It's lost its ability to track and that's not what -- ETFs are supposed to track the underlying. And that's the whole point. That's their whole value proposition. So, you just killed the heart of the ETF with the halt of creations, which occasionally I'm okay with, if it's like a country has a war or something. No, war's a bad example. Like in Egypt, they had a revolution internally, but not for *I just don't want all that risk of my balance sheet or I'm not into it today.*
- Rodrigo:** **01:18:18** Fair enough. Yeah, I mean, it is their own book, right, on fixed income issuance, so they got to protect themselves. I don't know, like, I mean, it seems to me like a volatility ETN might be something that you might want to steer clear from. I still see a lot of value in more plain vanilla type of offerings, especially in the commodity space where you can get that tax advantage. Because the thing is one of the biggest reasons why ETFs have taken off is because of their loopholes on the tech side with the APs being able to create and destroy units and do the swapping. So, that happened again by happenstance, and you get this massive benefit, and it doesn't work for everything. It works only for stocks, right? On

the futures side there's just no good option aside from that if you want to go with that.

**Eric:** **01:19:12** Yeah. There's some have come out that actually have no K1 in the name and they're able to use this Cayman ...

**Rodrigo:** **01:19:17** The Cayman blocker -- you're right so it's like DBC turned into PDBC, right? Because DBC was putting out a K1. PDBC put in a blocker. The issue with that is that what comes out of the blocker is income. So, it's better than a K1, it's just not the same. ETNs continue to win there. I think as long as they have that advantage, ETNs will win. But I agree with you that if you're going to do that, make sure that you can always -- if ... tracking get perfect tracking 100% of the time.

**Eric:** **01:19:53** There is market for a bank to step up and say we will not halt banks, and just own this whole space and provide this -- but as of now they're all guilty. Credit Suisse did it, UBS has done it, Barclays has done it, no one is safe. And that's the problem. You don't know when the next bank's going to just have this feeling to not do it. So, yeah, it's unfortunate because there is that benefit.

**Rodrigo:** **01:20:20** Right. All right. Those are the hot topics of the day. Anything else, Eric that we didn't cover?

**Mike:** **01:20:24** Yeah, anything else that's hot, or that we didn't cover in the book as well that was interesting or timely?

**Eric:** **01:20:30** No, I mean, we covered the big topics. And I think your reaction and feedback on those was really great. I think a lot of people even in the active space would largely agree to some of the points made here, like you guys did. It's not just this, like, oh, just buy an index fund. I try to layer it with a lot of the nuance in all this. But at the same time, just acknowledging that cheap beta is a hell of a drug. I mean, it is ... powerful.

**Mike:** **01:20:59** If it's truly a commodity, then cheapest price wins. That's it. And I think you pounded that home several times, and it's unassailable logic, right? You can't say no, but I want something different. Okay. Well, now we're having a different discussion. I like value add another -- it's a different discussion. Vanguard has become the low cost producer of beta. And so ...

**Eric:** **01:21:25** That's why -- I hope if you're an active manager, or somebody who is in this business, hopefully this book will, because I go into all different worlds, the trading world, the brokerage platforms, the advisory world. I really try to lay out how the Vanguard effect which I call The Bogle Effect, because I really feel like he was the anomaly is going to ripple in, and you have to have a plan for this.

But hopefully I say it in a way that's not too damning. And like I said, when I go over the mutual funds, I'm like, I've done the same thing. I'm weak.

- Mike:**           **01:22:01**           What's damning is not knowing. You got to know, you got to know. Make all the decisions you want now that you know.
- Rodrigo:**       **01:22:11**           That's right. Don't be an ostrich and put your head in the sand, right? Like, the value of reading something historical like this, and it's also entertaining because of the pair of personalities in it is that you now know. And you can make thoughtful decisions based on that. Or you can bury your head in the sand. It's up to you. But you gave it the old college try.
- Eric:**           **01:22:30**           Anyway, thank you guys for letting me come on again and talk about it.
- Mike:**           **01:22:35**           Thanks for coming. Where can everybody find you, too? Give us all the deets where they can find you, the name of the book again, the Amazon book, all of it.
- Eric:**           **01:22:42**           The Bogle Effect, just go to Amazon, probably easiest. You can find me on Twitter at Eric Balchunas. And I have a podcast called *Trillions* which is on all the podcasts and that's free. If you happen to have a terminal, a Bloomberg terminal, you can go BI ETFGo, and that is my little home. You know if Bloomberg is the United States, I run a small post office in Rhode Island and it's BI ETF. Yeah. Oh no. I'm so tiny there, I'm reminded I don't know, once a month. It's such a big place, but do have a lot of control over this one function and so that's where you can find me.
- Richard:**       **01:23:17**           Amazing. Thanks so much for your time, Eric. This is great.
- Eric:**           **01:23:21**           Yeah. You got it guys. Thank you so much.
- Rodrigo:**       **01:23:22**           Enjoy the weather
- Mike:**           **01:23:23**           Enjoy the weather.
- Eric:**           **01:23:24**           Thank you. Bye-bye, guys.
- Richard:**       **01:23:25**           Bye all.