EBI - Principle #1: Invest in Asset Classes

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Keith: Welcome to episode 13 of the Empowered Investor. My name is Keith Matthews and I'm joined by my co-host Ruben Antoine in today's show. In our last episode, we introduced Ruben to the listeners and we walked through his personal, really amazing story of how he grew up, how he entered the investment industry, and what made him choose evidence-based investing. Welcome back again, Ruben.

Ruben: Thank you, Keith. In today's show, we're going to continue that discussion. We're going to specifically talk about the investment approach, the investment philosophy. We're going to break the next four shows down into four key principles that each cover one of the sections. In today's show, we're going to speak about the first principle, which is to invest in asset classes. We're going to define what an asset class is and we'll discuss why investing in asset classes is a better alternative than others for most Canadians.

Keith: Absolutely. So well put. And again, part of the struggles and the challenges that Canadians have is there's so many choices of different types of investments and styles and strategies. There's so many voices telling them how they should invest. And what's I think so great about this investment approach is we're going to lay out four sections of the approach and that's going to be the four main principles. And it's like a map. It's going to share with our listeners how they should invest. So Ruben, let's start with what is evidence-based investing?

Ruben: So let me ask you first, Keith, just a quick analogy. If you were feeling sick today and you were to go to see a doctor and you have the choice between going to see a healer from an obscure cult who treats people using insight and prediction from his dreams or you have the choice to go to see a doctor who treats people based on scientific research, based on evidence, which one would you choose?

Keith: If you put it to me that way, I'm going for science. I'm going for evidence and I'm going for data.

Ruben: So exactly. So evidence-based approach is a more scientific approach to investing. We can define it as it's an approach where investment decisions are based on facts, on evidence, on what research has shown to be factually true. Other investment approaches would rely, for example, on financial predictions and economic forecasts. Evidence-based investing will rely instead on decades of research, on historical data. And those historical data have shown based on facts what have...

Keith: So what's amazing about this investment approach is it really does try to work on what works, pushing the BS, the smoke, and mirrors that we so often find in the investment industry, putting it aside and focusing on the things that will have a material impact and that will give and produce results. So within this investment approach, there are four key principles. And this is like a map that we're going to share. And the four key principles, they each build off of each other. So the first principle is to invest in asset classes. We're going to talk about primarily that principle in today's show. The second principle is to diversify your asset classes. The third principle is to use index-based or passively managed investments to capture the exposure of each of these asset classes. And then the fourth principle of the evidence-based approach is to increase returns. You may choose to tilt towards certain factors. So each one of these principles will be covered off in one specific show. Subsequent to today's one, it might be a bit technical but we're going to try our very best to make it easy to understand, fluid, and give some nice examples as to how we can embrace this approach. So Ruben, how would you compare evidence-based investing to other investment approaches?

Ruben: So like we are saying right now, there are many ways people can choose to invest. There's the evidence-based approach but there are also other investment strategies. Two main approaches that people may be familiar with are market timing and stock picking. So market timing will be when people are trying to identify in advance where the market is going. So if the market is going up, they will try to enter the market by buying investments. And if they think the market will go down in the future, they will try to exit the market by selling investments. The problem with that investment approach is that it relies on trying to predict the future, right? The future movement of the market.

Keith: Absolutely.

Ruben: So if I take an example back in 2016 during the U.S. presidential election, many experts, many analysts, many economists were predicting that the stock market will tank, will crash if Trump wins the election. And we all know that Trump did win and the market did the opposite of what people were predicting. The stock market went up in the following years. This is to show you how hard it is to predict the future, how hard it is to try to time the market even for experts. So you can see how difficult it can be for investors as well.

Keith: Yeah. And that's the experts. Regular investors often get caught up sometimes in emotions and thinking and biases. I recall back then when Trump was being elected, many individuals said, "This cannot be good. Whether we like him or not." What was interesting is the emotions took over sometimes and people made decisions based on that. And the reality is the stock market or equity market has done reasonably well since then. So if you made a decision based on that emotion, you'd later regret it.

Ruben: Exactly. Yeah.

Keith: So what I find also interesting, even you take today's context in the pandemic when we had the initial lockdowns of the economies in the month of March and April and the stock market corrected quite rapidly. It lost 35%, 34%, the S&P 500 in the matter of five or six weeks. Many people were trying to figure, "Okay, what's the prediction for the recovery?" And we used to hear about all these letters like it's going to be a V recovery, a U recovery, a W recovery. And then the worst recovery, of course, is an L. And each of these letters represents the direction of the stock market. So V is stocks go down and then they come right back up quickly. U is they go down, they stay down, and then they come back up. W is they go down, they come back up, and then they go back down again. And then finally they come back up. And then L is the worst, which is it goes down and then stays low for a long period of time. And most people are trying to figure out how do you predict that? And do you market time around that? And the irony is nobody even saw what was about to happen, which was we ended up with what people are now coining the K. Half the stocks have done really well, and the other half of the stocks haven't done so well. Either way, this ability to try to say, "How do I time? How do I move money around?" is very precarious. And I think, as you mentioned, it's a philosophy that some people think is a philosophy, but it is not a philosophy. If it was such an easy thing to do, you would see banks and financial institutions actually naming strategies after market timing. They would call it their ABC market timing strategy, and you don't see it. And I think that's a testament to even large financial institutions don't want to be encouraging people to do it.

Ruben: Yeah, exactly. So to continue on other investment approaches that are not evidence-based investing, there is the strategy called stock picking. So stock picking will be where an investor will try to identify five, 10, or 15 stocks to put in their portfolio. And they will think that if they choose those stocks, it's because they think that those stocks will be the best winning companies in the future. And again, I said future. So that strategy relies on being able to predict the future. And we all know it's extremely hard to know in advance which company will be the winner in 10 or 20 years from now. So I have a couple of examples to show you how this strategy is not necessarily the best strategy to be following. And I'm going to take Apple, for example. So Apple, we all know this company, it's a huge successful company. And recently Apple reached the 2 trillion valuation on the stock market, which is the first time in the U.S. this has happened for a company. And this is just two years after Apple became the first trillion company in the U.S., in the world actually. So this is a good example because it shows how successful Apple is. And iPhone has been a big contributor to that success. iPhone has been sold 2.2 billion iPhones since it was created in 2007. So this is huge success. So this is a very good investment. Now we all know that. But it's interesting to see what people were saying back then when the iPhone was created. If you were an investor in 2007 and you were looking at what experts were saying about the iPhones, would you have invested in the Apple stock back then? So I have a couple of examples here. So if we start with experts in technology, there is a CEO from Microsoft back then that said in a quote that there is no chance that the iPhone is going to get any significant market share. So this is just an example to show you that even people that know about technology, they didn't see the future possibility, the future positive outcome from the iPhone. Do you remember the Palm, Keith?

Keith: Yeah, I do. When I used to take the train from the suburbs to downtown for work, I do recall people pulling out this, that's the one with the little pen in it.

Ruben: Exactly.

Keith: And they would use that and take notes. And I remember everybody thinking that was the leading technology. That was cool. You had your pen, your pencil, and you could write on a pad and take notes. Absolutely.

Ruben: Exactly. Because it was like having a computer in your pocket. They were trying to combine that computer, that small computer, with phones for years. So in their opinion, there's no way another company like Apple will figure out how to combine phones and computers in a pocket size. So they were bashing the iPhone as well. And someone can say that investors will not be necessarily listening to tech experts about the iPhones because they were the competitors. So it's normal. They would be bashing iPhones. But financial experts as well were saying the same thing. People from Morningstar were saying that iPhones will not be a success. So they didn't see it. And if you look at, for example, other parties that didn't have any conflict of interest or were not competitors of Apple, what they were people like bloggers, journalists about technology, same things. You look at what they were saying in some magazines like TechCrunch, a really popular magazine on technology. They were saying that the iPhone will fail as well. You can see the examples left and center. Most people were not believing the success of the iPhones back then. So imagine an investor that was about to decide if they invest in Apple or not, how they would be feeling about that.

Keith: So your example, what you're suggesting is even though you look at the superstar company that we see right now, picking it at its winning stages early was really difficult to do. So the whole concept of stock picking where individuals are often trying to pick future winners, it's not obvious. And the numbers that we see from research and data essentially show us that individuals, mutual fund companies, management programs that are trying to pick the winners often don't get it correct. And their pools of capital don't do better than let's say the market. It's a great example. It works both ways. Individuals that think that something's going to be a great success might often turn out five, six, seven years later to be not such a great success. And what you're highlighting is the risks of trying to pick those individual companies. So you're talking about two approaches, stock picking and market timing as alternatives to asset class investing that don't work. And so you're highlighting why asset class investing should be considered the principal approach. So how do you define an asset class, Ruben?

Ruben: So an asset class would be a group of assets that share similar characteristics and behave approximately in the same way. So if we take the first example that most people are familiar with, it would be cash. Cash is an asset class. You go to work, you get paid, you can put that cash in your bank account or invest it in a GIC to earn a bit of interest. No matter where you put your cash, it's all under that umbrella, that asset class called cash. The second type of asset class that people may be familiar with is real estate. So your house is part of that real estate asset class, but also other residential homes like triplexes and commercial buildings, for example.

Keith: So here you're giving examples of, at the basic level for individuals, they've got the two types of investments: cash, and that's cash savings accounts, checking accounts, GICs, and then real estate. So anybody's home fits into this whole basket of residential homes in either their city or the country. And that's an asset class. Okay, very cool. So what about moving into asset classes in a portfolio? What are the traditional asset classes when it comes to thinking about investment portfolios?

Ruben: Yeah. So those are most in the financial asset class type of assets. So you can have cash in your portfolio, but also you can have stocks. So stock will be having an ownership in a company. That company can be public in the stock market or private. And bonds is another asset class. So bonds are when you loan money to another party like the government or corporate to earn interest. So that's why they are called fixed income securities. So if we put all together the four broad traditional asset classes are cash, real estate, stocks, and bonds.

Keith: Okay. And incidentally, those were primarily the major investment vehicles that pension funds used through the sixties, seventies, eighties, nineties, even the double O's. We'll talk about some of the new ones that are emerging. But so those are the four key ones. Can those be...?

Ruben: Yeah. So each of those asset classes, you can go in more detail. If you take stocks, for example, you can invest in Canadian stocks, U.S. stocks, international stocks. This is more in terms of region, but you can also invest in stocks of large companies or small companies or, like I said before, private companies like the restaurant on your street or public companies, which are the ones on the stock market. Bonds as well can be broken down into government bonds, corporate bonds. Real estate can be broken down into residential real estate, commercial real estate. So there are subclasses, sub-asset classes to those broad, typical asset classes.

Keith: Okay. In our next show, we'll talk about how one can diversify across these multiple asset classes and what the benefits are when you mix asset classes together. But suffice it to say, those are the main ones. What about alternative asset classes? Are there asset classes that others are suggesting should be in portfolios?

Ruben: Yeah. What we just discussed are the traditional ones, but then you have all the asset classes. Again, an asset class is a group of assets that are similar. So there is one called commodities and commodities is more diverse. You will include gold, for example, precious metals, or gold in that. It can be seen as an asset class. You can put oil, so people can speculate on the price of oil, infrastructure, agricultural products. So there are other types of assets that can be seen as an asset class as well.

Keith: Okay. All right. What's a hedge fund then? How does that fit into an asset class in the investment business? Those that put together pools of hedge funds often say it's an alternative asset class. Is it an asset class?

Ruben: So we hear that often, and I come from the hedge fund industry, and I don't necessarily agree. I don't see hedge funds as an asset class because basically most hedge funds, they will be trading, let's say, an asset class. So you will see hedge funds trading stocks. It's just that they will have different strategies. So you will see hedge funds having strategies like shorting the stocks or buying distressed companies. There's so many strategies. So I think hedge funds per se, it's not an asset class, but it's another strategy. It's different strategies that investors can choose to put in their portfolio to get exposure to asset classes like stocks and bonds.

Keith: I completely agree with you. I look at hedge funds and it's a supercharged, highly active, almost speculative investment strategy that essentially looks at a style and tries to trade and be quite predictive and look for big bets and try to produce alpha. We will be speaking about that later in the future shows as to why we don't believe this truly needs to be included in any investment strategy. Canadian portfolio. Okay. So major asset classes, we've gone into that. What are the benefits of asset class investing in comparison to the other two approaches that we spoke about?

Ruben: There are many benefits when we compare asset class investing, which is part of the evidence-based approach, with stock picking and market timing. We can look first at returns. So asset classes have a larger impact on portfolio returns compared to stock picking and market timing. There was a study back in 2002 that Dimensional Fund Advisors made. Dimensional Fund Advisors is a big asset manager. So they compare returns between portfolios of 44 pension funds managing $450 billion in assets. And what they found is that asset class investment determines up to 96% of the return variation between the portfolios. So this is comparing to stock picking and market timing only accounting for 4% in the variability of returns between those portfolios. So this shows you how important asset class investing is.

Keith: Yeah, and great point. And the irony behind that, something as simple as that research, the observations, the data is essentially that while stock picking accounts for 4% of the variations, so in other words, you'll get most of your return by deciding, am I in stocks versus bonds? Am I in U.S. stocks versus Canadian? Those are the decisions that matter. But most people often have a tendency of chasing ideas and big concepts and fads and they get caught up in trying to produce the returns when they really should be making their decisions based on asset allocation.

Ruben: Exactly. Yeah. The benefits are not only on the return side, there's another benefit which is just the instant diversification that you get when you buy the whole asset class instead of trying to buy stocks or predict movements of the market. And by having that much diversification, you reduce the risk in your portfolio. So for example, if you want to get exposure to the U.S. asset class, U.S. stocks asset class, one way to do it is to buy an index, the S&P 500 index. So just by clicking on buying that one investment, you get exposure to the 500 largest companies in the U.S. And there are other asset class vehicles that can give you exposure to 2000 companies, for example. So when you have that much diversification, there's less risk, of course, but also it comes with peace of mind. As an investor, you stop worrying about if one company in your portfolio will go bankrupt, for example, because the impact of this bankruptcy of this company will be so minimal when you own 2000 companies. This is a big benefit as well, that peace of mind that comes with that.

Keith: Yeah, you're talking about the soft side, which is very important, but investors' emotions, their sanity, their peace of mind, which is incredibly important. But there's also the performance advantage, which we're going to talk a lot more in two or three shows from now. But suffice it to say, the irony is if you buy the entire asset class, you keep your costs low, and you do it through index and passively managed investment vehicles, you will get the average return of that asset class. You get the asset class's return minus the small fees. But the reality is getting that average return is a superior return versus the alternatives of trying to stock pick throughout the asset class or hiring actively managed strategies. So this is a big aha moment for a lot of individuals because they often will say things like, "Why would I accept the average? I want better than the average. I want better than mediocrity." That just doesn't seem right. But this is one of the few fields where average is better than the vast majority of outcomes.

Ruben: Average is superior, yeah.

Keith: Yeah. And even in the Empowered Investor, the book, I remember the editor who was helping us came up with a phrase which was called "embracing the average advantage."

Ruben: Amazing. I like that.

Keith: Yeah. Yeah. And I thought that was really cool and very interesting. So those are all great points, great reasons why one should embrace asset class investing or invest in asset classes.

Ruben: Let me ask you that, Keith. If asset class investing comes with all these benefits, why have many investors not heard about it? Or if they have heard about it, why are they not adopting this approach?

Keith: Honestly, I think a lot more investors are and financial institutions are moving towards building fairly decent diversified portfolios that include Canadian stocks, U.S. stocks, international and emerging fixed income, REITs, and maybe one or two other types of... So we are seeing more of it. The problem is it's all being executed with high fee, actively managed strategies.

Ruben: And...

Keith: And that sort of takes a lot away from it. But there are still a group of people that they don't know and they succumb to the noise that's out there in the industry where they end up doing the chasing and they end up thinking investing is just about chasing. They don't necessarily know. So they need to become aware. They need to understand how this works. They need to understand that there is a better way to invest and that will get them the returns they're looking for. There's a massive marketing machine out there that lives and breathes on activity and encouraging those to think about activity. So I think that's one of the main reasons why some people just can't seem to move forward on it. And so hopefully with shows like this, other shows, books, and I know more Canadians are embracing this than ever before. So I really believe we're at this tipping point now where Canadian investors are waking up saying, "You know what? This makes sense. This approach makes sense." So I think it's all positive ahead, Ruben.

Ruben: That's good.

Keith: Yeah. So listen, Ruben, we're going to wind the show down now. And this has been a great show for discussing principle one. What are your key takeaways for the listeners?

Ruben: Yeah, I would say trying to pick winning stocks or timing the market, as we showed, it's very hard, even for experts and finance professionals. It relies on trying to predict the market, the future, having a crystal ball, which we all know no one can really predict the future. So a more sensible and prudent approach, but a really very effective approach, is simply to buy the whole asset class. And this is part of evidence-based investing. And it comes with the benefits we mentioned and it comes with peace of mind. So this is what we believe is the best for investors.

Keith: Okay. Very good. The only thing I would add to that is asset class investing, it's going to sound a bit dull and boring, requires patience. This is not a win big strategy. This is a win over the long-term strategy. And so you really are playing the long game here. So you've got to understand how that compounding effect could work. You've got to understand how reducing errors is part of this process as well. So those would be the takeaways that I think are valid.

Ruben: That's a very good point. It's not a get-rich-quick scheme, so it requires discipline. So let me ask you that, Keith. Now that we are wrapping up, what are we going to cover in our next few episodes?

Keith: Well, Ruben, this is great. We're going to continue. We've got two or three more episodes on the investment philosophy, the evidence-based investing approach. Next episode, we'll talk about how do you diversify a portfolio properly? Why do you do it that way? The episode after that, why should you consider index funds or passively managed assets? The episode after that, why tilt into certain factors for long-term extra returns? And so we're going to be doing deep dives in that. Thank you to all the listeners for tuning in to episode 13 of the Empowered Investor, and we look forward to seeing you in two weeks from now.

Ruben: Thank you. And see you in the next episode.

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