Ep:118

The Index Investing Revolution: Lessons from "Tune out the Noise"

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My name is Keith Matthews, and I'm joined by my co host, Marcelo Taboada. Marcelo, how are you today?

Marcelo: I'm doing great. I'm excited about today's show. For history lovers and history buffs, it's going to be an interesting one.

Keith: Well, it ties into our last episode where we talked about four global investment management trends. And in particular, trend number one that we discussed was the rise of index funds. And so, today's show is really going to take a deeper dive into how that happened. And it's all based on the movie "Tune Out the Noise". And this movie, "Tune Out the Noise", is now available for everybody on YouTube. It's a wonderful movie. We'll speak entirely about it. There're some amazing stories, but it really highlights the beginning of index funds and the pioneers involved and the obstacles they had to face.

Marcelo: Yeah. And it was directed by Errol Morris, which is an Academy winning director and very famous. And he has a very particular style, how he directs, and people will pick that up in the movie because he has a very interesting style of delivering messages.

Keith: In his documentaries he asks questions to the interviewee. So, they provide that sort of direct interaction. Right in the, in the documentary.

Marcelo: Yeah. Which is interesting. Yeah.

Keith: And now the movie was financed by Dimensional.

Marcelo: Yes.

Keith: But completely directed with full creative license by Errol Morris. And what he did essentially was interview everybody at Dimensional. And then he created the storyline, he decided what questions, he decided the direction. So let's just start with the basics. We're going to kind of jump into the basics, the main themes of the. Of the movie, why it's an interesting movie. We're going to share stories that we picked up from the movie. So, what is the movie? What's it about? What's the foundation of the movie?

Marcelo: Yeah, so I think the foundation of the movie is essentially the genesis of this revolution that started 40, 50 years ago, like early 60s, beginning of the 70s, and how it's like it's essentially born in academia. It's how it started. And I'm a history buff. Like, the story is just remarkable. Like, there are so many moments that I'm watching this and I'm like, oh wow. Like this is just like right moment at the right place type of story. And you look at what it's done now in the investment industry, it's almost comical how it started. A lot of luck in there. But the people involved in it, they all have remarkable stories and incredible character too. Like what they had to go through. And it's just like I love the whole story.

Keith: Well, in a second, you'll be telling us some of those stories.

Marcelo: Of course, of course.

Keith: Let's talk about the current state of indexing right now for a couple of minutes just to kind of give some perspective as to what's going on. And then we're going to dive right into the movie. So, let's spend a few moments just kind of what's the landscape of indexing in the world?

Marcelo: It is essentially taking over now. The United States, China and a few other markets are like most dollars are managed by index funds or passive investing. Some countries are lagging, but we talked about why Canada's lagging last show. But it's essentially a revolution. People are voting with their dollars. More money is leaving active managed strategies and it's going into these passive strategies that you know, we have evidence that it works and they're cheap and they're simple and they're easy to understand and that's essentially what's happening.

Keith: You're 100% right. And I'm going to jump in with a couple stories right now actually and then we'll go to the movie. I was telling this to you just prior to the show that the story I have is a story of two different retiree couples.

Marcelo: Right.

Keith: And one of the retirees, and this is them coming to the office and I'm providing them a second opinion on their portfolio and on their financial affairs. The first couple that I met was in 2004, 2005. And the second couple was this week. In 2004, 2005, two 71-year-olds showed up in my office and they showed me their statements, and I reviewed that and they had three securities in their portfolio that made up their entire nest egg. Now it happened to be an income trust which back in the day were all based around resources, sort of farming and harvesting some form of resource and paying out the income. But suffice it to say it was an undiversified portfolio. And I told them it's a high-risk portfolio, highly concentrate and in my view was highly speculative.

Marcelo: Yeah, they probably liked it because it pays well.

Keith: Everybody was talking about it and, they actually felt it was a reasonable portfolio. Fast forward this week. I had a similar experience dealing with two 70-year-olds. They showed me their portfolio, and it was 100% built on exchange traded funds which are tracking general benchmarks, indices.

Marcelo: That's amazing.

Keith: It's a sign of how things have changed and how the world has adopted and embraced this entire process.

Marcelo: Well, I see it with my friends. I think anybody right now who's investing, who's not with an advisor or in a bank, is doing indexing. And I have friends who are doing indexing, and they don't even know exactly what it is, but they just know it's the right thing to do. So, I think that's like you wouldn't see that 10 years ago.

Keith: No, my kids, well, Jackson's in the business, but my other two kids that are not in the business are 25 and 29. I know that their entire portfolios are built off of VEQT, which is an all equity etf and that all their friends are. And you would never have seen this 15 years ago.

Keith: Now maybe I had an influence in that because I would have directed them that, but I know that they're all talking amongst their friends, and this is happening. So, this is part of this revolution that is now we take for granted. Everyone thinks it's just kind of like wasn't that what you just kind of do now you have access to this? But it didn't start that way. So now we're going to go back. It started in the 60s and this movie does a wonderful job highlighting the beginnings, the obstacles people faced and sort of how this whole process and democratization of investing started. So, let's go back to the 60s. Talk to us about some of the things you remember in this movie.

Marcelo: The first thing is essentially the investing world was dominated by active stock pickers. Right? And along came these guys and you know the stories the movie starts with. David Booth, which is the founder of Dimensional, is a Kansas City boy, you know, like he is a shoe salesman. He goes to the University of Chicago to complete a PhD and then he quits the program and starts the company. But he meets all these academics along the way. And it's also around the period where more data's coming in, like the computers are starting to be available to crunch data. And at the University of Chicago, they created it's crsp, the center for Research Security Pricing. But they have all this Data. And now academics have access to data, and they can analyze whether stock pickers are doing their job. Do you have all these academics who end up figuring out look like the evidence shows that they don't? And David Booth goes on and funds the business, starts the business. And based on this idea that. Based on evidence. And I just find that it was like a counterculture moment because the status quo was like, you don't do that. You just pick stocks, and you pick the winners and you avoid the bad ones. But the evidence shows that it doesn't work.

Keith: And this isn't just retail. This was institutional money was being managed by groups of individuals who would pick stocks. You're right. That's exactly the story. Their idea was it's better to pick the entire market. This movie is about the people that thought that way and came up with concepts about pick the entire market. And you're better off getting the market average versus trying to do something else. And they had so much criticism, fired it their way, which this is un-American. You can't do this.

Marcelo: You're settling for average.

Keith: You're settling for average.

Marcelo: But it's also the convergence of ideas, because I think you had. The movie does a great job at this, at showing how you have access to all this data. But you have academics like Eugene Fama who created the theory of not created. But they came up with the efficient market hypothesis, which is a way of thinking about the market in terms of, look, the market is efficient. It incorporates all available information. So, it makes sense. Right? But it wasn't for people who are outside the investing world. It makes sense, but it wasn't easily adopted. People were rejecting these ideas for a long time. It was rocking the boat for. To use colloquial term, right?

Keith: And they were saying, you know, why would settle for average? Average isn't good. You need superior. I found interesting the rebuttal of the early indexers was, fine, we may be giving you average, but please know that when you use active management, you are settling for below average. So, what's the higher number? Well, it's average and it takes a bit of time to kind of let that sink in, but it's a very powerful concept. And so, this movie really shows the beginnings of this and the struggles that these early adopters and pioneers had to go through. The first institutional index fund, I believe was created by Wells Fargo in the very early 70s. So, 71. And then Vanguard produced or created the first S&P 500 index fund for retail market in 1976. That's it sounds like it's a long time ago, but it's really not that far ago.

Marcelo: Jack Bogle, the founder of Vanguard, and you see this in the movie, he got all the research that the people at the University of Chicago had done and had used in the Wells Fargo.

Keith: He got some of the data. I believe that Bogle did his research piece on this topic while he was in Princeton.

Marcelo: Correct? Correct.

Keith: But he did get a lot of the actual live data.

Marcelo: And, I mean, a lot of the academic studies were around that. Right. Like are active managers beating the market because they're lucky or because they're good? All the data showed that you couldn't separate luck from skill. And that's the whole basis of the efficient market hypothesis, right.

Keith: Absolutely. One of the things that you and I both identified in this movie, "Tune Out the Noise", is that while these are all academics that are creating the first early stages, they're individuals of grit. Their lives were not easy. They were not straightforward, and they were determined. They were committed and determined individuals. And we encourage all of our listeners to watch the movie. You will see that these were.

Marcelo: incredibly resourceful individuals, too.

Keith: Yeah, 100%.

Marcelo: They just wanted to get it done.

Keith: Let's talk about a few of the stories that we picked up. Some of your favorite stories. Give me two of your favorite stories, Marcelo.

Marcelo: The first one is just David Booth, right. Like, he's just this kid from Kansas City. He becomes a shoe salesman and has this moment of realization that, you know, you have to sell to make commission. Right. But he's like, very principle in the sense that he is not afraid to tell the client if it's not the right fit for him to tell him, look, this is not your best look. Maybe let's try another shoe instead of getting the quick sale in a more expensive shoe. So, I feel like these are people of, like, values. Right. That have carried out throughout the business and that it shows when you deal with a company like Dimensional. Right. The other story that's fascinating to me is Mac McCown, the other pioneer in the industry, came from a farming background. And he says in the movie, like, I had an advantage over city kids because when you're a farmer, it's all about numbers and statistics. It's like, how many. How much room do you have? How much is the crop going to yield? So, you're thinking in terms of numbers and statistics. So, I found the connection very remarkable in the way he found it. Right.

Keith: Well, that's a fascinating story.

Marcelo: Yeah. So, I find the stories like, you know, the backgrounds, these people had, you know, the other guy in the movie. I mean, you asked me for two stories, but the other. The other fascinating story is Rex Sinkerfield, the other guy, who's from this same group of.

Keith: He's one of the. He's one of the co founders.

Marcelo: Correct. And he's like an orphan. Right. Like, none of these guys had easy upbringings. Like, David Booth was, like, almost drafted to the. I mean, the story is almost surreal. He shows up on draft day, right, to the gymnasium, and the guy who's supposed to draft him says, hey, what are your plans? And he's like, oh, I'm enrolled in a PhD for next year. And he goes, okay, go try that out. We'll see you next year. And then the rest is history. Right. Like, what if he got a guy that wasn't chatty and was just grumpy that day and just stamps the form and off, he goes. Right? It's. You know, we would probably still have something like. Looks like indexing. I'm not trying to discredit that, but the whole serendipity in the story and the genesis of the story is just so funny.

Keith: Absolutely. 100%. And we've met all these people.

Marcelo: Yeah.

Keith: When we go to Dimensional conferences. I think I've met, met and, or listened to David Booth 20 times in person.

Marcelo: Well, I've met Gene Fama in person and Nobel Prize winner, recognized in finance. He's a superstar. He's like one.

Keith: What did you say to him?

Marcelo: I just like; can I have a picture? He's like, sure. And then I found out. I found out that he doesn't like doing that because he's a very humble and to him, kept himself type of guy. And they're all very down to earth. And like, that comes across in the movie too.

Keith: It sure does. Some of my favorite stories, too, actually. A little bit more. You went back to the early days. My stories are built more on the later days. David Butler, who's now the CEO, co CEO, had a story, a great story, about how he came to realize that the investment industry is filled with a lot of noise and noise could be stock suggestions, it could be stock ideas. But he essentially bought into the idea that Boston Chicken, by way of his broker's recommendation, would be this big thing. And he tells the story of how he invested in it and lost a ton of money. And that was his half of his net worth. You know, that was his aha moment. Sooner or later, he ends up applying to a job at Dimensional and fast forward 20 years, you know, he's now the co CEO. And these were life stories that occurred, I believe, probably in the. In the 90s for David Butler. And the other one was. Was Mark Hepner, who openly states that he had done very well in normal industry. I believe it was the pharmaceutical industry. And he had sold his business. He had quite a small fortune that.

Marcelo: He had at an early age, too.

Keith: At an early age. And he had invested in a regular investment approach, was filled with active money management stocks.

Marcelo: Yeah.

Keith: And then, you know, he happens to kind of be tracking some of this stuff. And 10 years later, he says, I wonder what my money would have done if I had been invested in index funds. And he highlights. I think it was a $30 million difference. And at that point, I believe he yanks. He tells the story of how he yanks all his money out of active money management and starts an investment advisory firm, probably invests his own money that way, and then creates a service to help other people invest that way. And so really fascinating stories pop up in this documentary. Marcelo, what were some of your main observations that you want to share with some of the listeners on the movie?

Marcelo: I think, for me, boils down to simplicity and how you don't need complexity, you don't need complicated portfolios, you don't need all these bells and whistles. Like, you know, a traditional index approach that lowers fees is a perfectly fine approach for a lot of people. I would say everyone. And, you know, that's the way I invest. That's the way our clients invest. And I can see a difference it can make when you have this framework and it's simple and it's easy to understand, and it removes all this BS around it where, like, you have to be acting and like the news. It's constant noise. Yeah, that's my takeaway because. And you see it like there's no. The reason you're seeing a revolution is because it clicks on people. Once people get a grasp of how it works and removes this idea that you can actually outperform the market, it adds peace of mind in the end. And that's all you want.

Keith: Well, the simplicity definitely comes through in what you're stating in the way they view this entire approach. It even shows up in David Booth's artwork. Yeah, talk to us a little bit about the art, because the. The artwork does come through in the movie as go through. They do a lot of shots in David Booth's extended landscaped backyard, which is just like. It's not a backyard. It's Like a museum.

Marcelo: Yeah.

Keith: What did the artwork mean?

Marcelo: The art is, like. It's very abstract, you know, in the sense that probably not gonna be pleasing for a lot of people. Right. But one common theme among all the art is that it's very simple. There are no complex structures. It's like two colors, one structure. I mean, one of the representative pieces in the movie is these two columns that are just, like, stuck together. And they have a very nice visual impact, but they're just white and they're very heavy, and they look very nice, but they're not complex structures. And I feel like they drew that connection in the movie. And I think David Booth is a person that's drawn to simplicity because you have this concept of art, which can be very complex in some ways, but the stuff that he likes is very simple. There's not much complexity there.

Keith: Well, I think it's simple, but incredibly elegant.

Marcelo: Yeah, that too. Yeah. Yeah.

Keith: You know, and I think that's what the visual parts.

Marcelo: Less is more type of thing.

Keith: Yeah, less is more, and less is understandable and clean. And incidentally, for those that will watch the movie, I believe David has commented or suggested that when he's no longer here, part of his legacy would be to make that property and the land and the space available for civic activities, for research activities, for connections to universities. It's part of how he gives back to the community, in addition to so many other things that he's done. As a side note, I believe this is the number, but I think he donated $300 million to the university of Chicago to continue the legacy of investment management research.

Marcelo: I believe they named the business school after him. Right?

Keith: He did. That's right. Okay, so, Marcelo, let's move. Let's keep on going. This is fantastic. Couple personal stories now I'd like to ask you, and then we're going to kind of wrap up with sort of a conclusion. How did you discover indexing?

Marcelo: Yeah, that's a great question. So, my background is in more liberal arts and economics, but so I knew a lot about investing when I graduated university. And I remember I had this money that I needed to invest, right. And I went on Google, and I started researching, and I fell into this website, which you're going to know. It's a Canadian couch potato, which is Dan Bartolotti and Justin Bender. So those guys were doing a lot of stuff about, like, ETFs and, like, simple portfolios, keep your fees low, Intel. Intellectually, it made a lot of sense to me. Like, you know, you have this idea that the market is, you just ride it, and you take advantage of people trading every day. And at the end of the day, the market is a disagreement, right. Like some people agree, some people disagree, and they meet in the middle, and they pay a price. Right. Somebody has to buy; somebody has to sell. So that intuitively I knew how to that how that worked. But the whole approach that you could buy just an index fund was just amazing. It removed a lot of stress. The other thing too is I'm a person. Two things. I'm a person drawn to simplicity. I don't like complexity in my life. I don't like bells and whistles. I like things that are simple and easy to understand. Second thing is that I worked for a company that sold active mutual funds. And one of the jokes was that everybody who worked there would do index funds for their personal portfolios.

Keith: Come on. Really?

Marcelo: So it was just like a funny thing that they were selling this product.

Keith: So, they sell active, but they invest index.

Marcelo: Correct. And then, you know, I would get on calls with like portfolio managers and you would realize that the strategies looked very similar to the index, but they're just like 10 times expensive. More expensive. Right. So, I think the kernel of my finding was those two guys, the Canadian couch potatoes. But from then on, I was a true believer. And I remember when I left my old company, I was like, I wanted to work because I worked with a lot of advisors. Like it was crazy to me how they chose mutual funds, how they moved around stuff that was just like chasing performance, weren't acting on the client's best interest. And when I found TMA, I was just like, okay, this makes sense, right? It makes sense. I want to work for a firm that one believes in an evidence-based approach and is client centric. And to me that's everything and values, It's something that can be translated to many things. And just because you advance in your career and you want to do well, you do not need to sacrifice those. And to me, that was very important.

Keith: Powerful comments Marcelo, I remember the day you first came into the firm. You were so eager, you were so keen and there were a lot of applicants, but we knew you were the right person to become an advisor and you're doing a great job.

Marcelo: Thank you.

Marcelo: What about you?

Keith: My personal story goes back to would it be 1994 ish, when I was an institutional bond trader and my aha moment when I realized that there's a thing called an index and you can actually manage your money that way was when we were sitting around a bond desk and you know, you start. Keep in mind our job is to trade bond back and forth with clients and take a little piece of money every time that happens. My world is transactions. And so, what I discovered was one of the most boastful managers who would brag about everything and was actually quite challenging to work with. Once I actually sat back and I reviewed that manager's performance, I realized he was fourth quartile performance. Which means last group. I couldn't believe that somebody could be that brash and still be such an underperformer. And only in the investment management business will you see this. And that's when I discovered if you just would invest in an index or an ETF back then, you'd be way better ahead. That's when I started because I was first using actively managed low-cost mutual funds, Altamira and Fidelity and Templeton to get international exposure. Then I switched it to TIPS, Hips, which were the early exchange traded funds and Spider. That's when I embraced the whole process. That's for me, my aha moment. So, you know what I find fascinating about this whole approach is every single person at one point gets an aha moment and they're drawn to it. And this movie is just such a wonderful walk down. If you're interested in how, it all began, how it all started, we're all doing these things now, but how did it start? Who were the original pioneers? What were their challenges? What did they have to fight in order to get this kind of these ideas forward? It's a wonderful way to look at that historical component. Marcelo, your takeaways.

Marcelo: I will go back to simplicity. You know, simplicity adds a lot in not only in your investing approach, but it can also add. I truly believe that when you have your finances managed in an approach that's simple and you can understand, it allows you to just have less stress in your life and move on. Because we all know, Keith, money stress is one of the worst things in life. To me like that when those two things happen, like you remove that stress and you have simplicity, it's just a much better recipe for a better life.

Keith: Well said. Well said.

Marcelo: It may sound grandiose, but I truly believe that.

Keith: Yeah, well, listen, it's. At the end of the day, this process brings peace of mind and feeling too. And confidence.

Marcelo: Yes. And there's a line in the movie that really stuck with me, and it was one of the consultants that works for dimensional. And he said not many professions have access to people's dreams. And it is an immense privilege that we get to sit across the table from people and people trust their dreams to us. And I find, like, that's such a. It gives me a lot of purpose.

Keith: Wow. Okay. Well, that's a wonderful way to end the show. Marcelo, thank you for those final comments.

Marcelo: Okay, Keith, before we go, you need to give me your takeaways.

Keith: Okay. So, look, the takeaways in the movie, I think David Butler summed it up very well. Markets, work, costs matter. Diversification is your friend.

Marcelo: Beautifully put.

Keith: And I think you need to keep that in mind as you build portfolios and when you work with advisory firms that build portfolios for you and with you. So with that, folks, please take some time. If you're interested in the history of how all this started, you gotta watch “Tune Out the Noise”. It might now, we're just giving you a warning. It might take you a few nights to kind of clip through it, maybe break it up in a few evenings. It's a documentary, remember, so it's not an action thriller. But it is a very worthwhile show.

Marcelo: Yep.

Keith: So, thank you so much and we'll see you next time.

Marcelo: Thank you.

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