JW S03E12 John DeGoey

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SPEAKERS
Pat Bolland, John DeGoey

Pat Bolland 00:15
The investment community is perpetually optimistic. But is that a good thing John DeGoey is a portfolio manager in Toronto, and he's outspoken in the Canadian financial advisor community. And in his third book, Bullshift, John discusses how optimism can be detrimental to the financial health of your investments. John, great to see you again.

John DeGoey 01:03
Great, thanks so much Pat.

Pat Bolland 01:05
John, third book, but your principles go back to your first book. And one of the books you've written called Stand Up, you talk about in the stand up stands for scientific training, unnecessary disintermediation underpin professionalism. So set the stage a little bit, what are you talking about?

John DeGoey 01:23
The simpler acronym would be PDF, people, you know what a PDF file is professionals disclose facts. So the the point that I'm getting at is that if you want to work as a professional, any major profession, you could be a lawyer, you can be a doctor, you need to be able to have your patients slash clients understand the evidence, and you should be making recommendations based on the evidence. And the concern that I had in stand up and that I've had throughout my career is that a lot of what goes on in the financial services industry is really rooted in sales. And sales does not bad oven by itself, but it's different from evidence.

Pat Bolland 01:59
Okay, so the truth is about how you should handle customers, and you're suggesting that the investment industry doesn't handle customers well?

John DeGoey 02:07

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Not certainly not as well as it could I, you know, it's not awful. But there's certainly room for improvement. And I think the point that I'm getting at is that there are a lot of things that are presumptive, that are not always fully disclosed. If you don't ask, they won't tell. And the industry works fine. And as long as the advisor is not brazenly nefarious, there's nothing massively wrong. That goes that in that goes massively wrong most of the time. The one problem that I would talk about with stand up is that certain advisors, especially on the mutual funds side, there's evidence that shows that they are misguided, which is to say they believe things that are not true. And now the problem is when you come to an expert, and that person gives you advice, and with the best of intentions, but they give you advice based on things that are nonetheless incorrect. And you follow that advice. You could be harmed. Unwittingly, even the adviser giving the advice even after the fact might might be unaware, they would be oblivious to the harm they're doing, because they honestly think they're doing things right.

Pat Bolland 03:08
Give me an example of something like that. I mean, I see what you're saying that the advisor is doing the best he can, but sometimes he doesn't get it, right.

John DeGoey 03:16
Okay, so a paper came out in late 2016, called the misguided beliefs of financial advisors. And the the academics used two different mutual fund companies, they got data from 20 or 25 years, they had a few 1000 advisors and a few 100,000 clients, and they reviewed the data. And what they found was that these advisors, Chase past performance, ran concentrated positions, and didn't really pay any attention in one way or the other to product cost. And in fact, we know that past performance is not indicative of the future, you should diversify and not concentrate. And and cost is a very strong correlation to performance. And it correlates negatively, which is to say, high cost products perform less well than low cost products, all else being equal. So advisors do these things. And they did them even with their own accounts. And they did them even after they retired, because they honestly believed it was the right thing to do. But obviously that wasn't the case.

Pat Bolland 04:11
And that's the way they were trained, obviously, but do they have a fiduciary duty to a keep the best interest of the client at heart and be learn the you know, if they're making mistakes, and they've been trained to make mistakes? Shouldn't they do something about that?

John DeGoey 04:28
Well, yeah, so I think I think the responsibility for systemic mistakes, I think rests with the industry and how they train their advisors. The short answer is no, there's no real fiduciary duty for most advisors in Canada. The exception are people like myself, who are portfolio managers have a fiduciary duty, and if you're a Certified Financial Planner, you have something very much like a fiduciary duty for your financial planning obligations. But in terms of giving advice if you're just a securities registrant or a mutual fund registrant, all you have to do is make a recommendation ones that are suitable, which has a lower standard than a fiduciary duty. Okay, so

Pat Bolland 05:04

who's at fault then? Is it the the mutual fund companies that are supplying the products? Are they not educating the advisors? Or is it the advisors, home companies, if you will, that are lax?

John DeGoey 05:17
Yeah, it's an open question. And I think there's a lot of blame to go around. And the research merely said, what the problem is, they didn't identify what where it came from, and they didn't offer any solutions. So one of the things I'm talking about now is I'm actually I've done a course for for Newcomb, the people who do investment executive and advisors edge asking people to reflect upon precisely that, in my opinion, you hit the nail on the head, it's most likely going to be the product suppliers, and the employers of the advisors that are responsible for these misguided beliefs. But that's my hunch. No one has any evidence to support that no one has any evidence to contradict that. The fact of the matter is, as far as I know, no one can it's just your story versus mine versus someone else's, because there's no, there's no smoking gun evidence to prove anything.

Pat Bolland 06:05
And not in defense of the product suppliers. But I know a lot of out there, they just consider that marketing, don't they?

John DeGoey 06:11
Right. And that's my point from a moment ago. The industry has a culture of sales and not not a culture of evidence. And if you're a doctor, you don't, you shouldn't be making recommendations for which pill to take based on which which pharmaceutical company had a hot sales rep. In your office to talk to you last Friday, you should make the recommendation based on which pharmaceutical is best for your circumstance. Similarly, when it comes to investment products, you should recommend the products are the most suitable for the client. But sometimes, and I don't know, if it's only a few of the times, or most of the times, or I don't, I don't know exactly where the line should be drawn. But sometimes, the recommendations that are being made are being made for reasons that are less than empirical reasons.

Pat Bolland 06:58
Yeah, but that could be based and your point going back to sales, it could be based on how the advisors get compensated. And they might get compensated differently depending on the product they sell.

John DeGoey 07:09
Right. And so this is, that's another element of the problem. So embedded compensation is a problem all by itself. But the paper with regard to misguided beliefs showed that even though misguided beliefs even though embedded compensation is a real problem in terms of agency and advisors, giving advice that's based on the best interests of the client, these other things persist. Nonetheless, even setting even even if you solve the embedded compensation problem, you still wouldn't solve the problem of advisors winning concentrated positions chasing past performance, and not paying attention to product costs. These are products that are above and beyond the compensation problem. So as you can see, it's it's it's pretty multifaceted.

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Pat Bolland 07:52
I want to get back to our introduction, because we're talking about the investment biases, optimism in this particular case, and you write about it in bold shift. What do you want? Walk me through that as well.

John DeGoey 08:04
The industry has a vested interest in keeping people optimistic, because if you're optimistic, you'll add money to your portfolio, they'll tell you to take a long term view, which keeps you invested if there's going to be some market turbulence. And I'm going to say that about 19 times out of 20, that's probably pretty good advice. It works out very, very well. The question that I'm asking in the book is implicitly and sometimes even explicitly is what happens that one time out of 20, when we have a really, really bad market, and it goes down further than anybody ever experienced or ever anticipated. And it stays down longer than you anticipated. How will you cope? Because a lot of the coping mechanisms that advisors have when they speak with clients is, oh, don't worry, we'll take a long term view and then they'll they'll define a long term view is three years or five years. Well, what if we have a lost decade? And Pat, here's an example, the Nikkei 225 in Japan hit an all time high at the end of December of 1989. It still hasn't recovered. So if you're a 50 year old in in Kyoto, and you've got your life savings invested in Japanese stocks, and your advisor says, Oh, don't worry, you're going to come back. It's going to take a long term view. We're now 1/3 of a century later, and you're either dead, or you're still waiting for your portfolio to come back. And I think we do a poor job collectively as an industry in keeping people properly calibrated, and helping them to understand exactly how bad things could be. We overestimate how that will get out of it soon enough that we'll deal with it easily enough. Yeah.

Pat Bolland 09:41
But the 19 times that you're correct. I mean, it works out. So they say what you're doing is playing the odds ... 19 times out of 20 I'm going to be right so every time the market goes down, I'm gonna buy more, isn't that

John DeGoey 09:55
so that's certainly right. As I say most of the time, it works out fine... My concern and my question in the book is, what what are we doing collectively as an industry about those one off those once in a generation blips that are uncommon and that are unexpected. And here's an example that I'll that I'll use in 2002, a guy that have Daniel Kahneman won a Nobel Prize for something called Prospect Theory. You may you may know, Danny Kahneman because he wrote a book called Thinking Fast and Slow 10 or 12 years.

Pat Bolland 10:24
Right, right.

John DeGoey 10:25
So what he showed was he and his research partner, Amos Tversky, showed that people feel the pain of a loss twice as acutely as the joy of a game. So it's an asymmetrical response to whatever the market does. If you feel a pain that acutely in the market goes down, you're more likely to panic and sell than you think you would be because you think, Oh, if it's if it's a 10% gain, I'll feel fine. And it's no big

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deal, a 10% loss, I can handle that. But when you start thinking about a 20% gain and a 20% loss, and a 3% gain and a 30% loss, at some point, those losses, those very severe losses will cause you to panic. And it will be at at that time when your portfolio has gone down like it has never gone down before. And my worry is that if it were to happen, and I actually think that we're in a situation now in the second half of 2023, where the yield curve has been inverted for a year, and interest rates are at a generational high and debt levels are at all time highs for both households and governments. There's a lot of things and valuations are high, the cyclically adjusted price earnings ratio for the s&p 500 is over 30. So there are a lot of things that could go wrong. And we're walking a tightrope right now, and central bankers are trying to engineer a so called soft landing. But if they fail, and the jury remains out, I think things could get very bad, very, could go very go south very quickly and very severely. And I'm worried about how psychologically prepared, both investors and advisors are for that kind of an eventuality,

Pat Bolland 12:01
you bring up an interesting point, because Kahneman was kind of on the leading edge of what they call behavioral finance. And that's exactly what it's about how people react. So what's an investor supposed to do? If this bias exists in the marketplace,

John DeGoey 12:17
the best thing to do is to reflect upon your risk profile now, so before before anything hits the fan, what you do is you should sit down with your advisor if you have an advisor or do it by yourself and look in the mirror, if you're a do it yourself investor, reexamine your goals, re examine your risk profile and make sure that your your portfolio balance is consistent with that. And if you are worried as I am, then maybe you may, you might want to take some steps to make things a little more conservative. So as an example, a scattered portfolio of 6040 60% stocks, 40% bonds, but within within the parameters of the industry, you're allowed a 10% variance. So you could go to be as conservative as 50% stocks and 50% bonds. And then even within those things, you can go from corporate bonds to government bonds, you can go from long term bonds to short term bonds on the stock side, you can go from emerging economies to developed economies, although emerging economies are cheaper, you can go from growth stocks to value stocks, you can do things to take risk off the table while still reflecting your overall general thrust of the direction you want to go.

Pat Bolland 13:23
Okay, so I love to hear your opinion on something like active management, where portfolio managers somebody like you picks individual stocks and tries to do better than the stock market versus passive investing where they play in broader indices and you take whatever the stock market gives you because in theory, active investing should keep you away from trouble spots.

John DeGoey 13:48
Yeah, there's no evidence of that. So that's that's one of the things it's one of those stories that the industry likes to tell because it it drives people to active management and active management is more profitable for the industry. People over Standard and Poor's put out research semi annually six times over six months in all major markets Canada, the US, Japan, Italy, UK, you name it, and all major asset classes for active versus passive, over 135 and 10 year periods. And in all asset classes under virtually all circumstances. The very clear trend is the majority of active managers underperform their their

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investable benchmark, and the longer the time horizon extends, the more likely it is that they will underperform. So again, back to your point a moment ago Pat about playing the odds and you know, the the likelihood if you're if you're investing over a one year time horizon active passive it's it's a toss up, it's 5050. But once you start going into three years in five years, a good rule of thumb is one over N the number of years so that were 10 years, you only have about a 10% chance of beating a beating a benchmark using an active product, all else being equal, and of course most people will have six or seven or what Ever products in their portfolio? Well each, if each of those six or seven has a one in 10 chance over a decade, the chance of the total portfolio of performing a splendid benchmark is going to be only two or 3%. And of course, if you go 2030 4050 years, because the industry says take a long term time horizon, it rounds to zero. It's not impossible, but it's highly improbable that you'll meet a benchmark, an investable benchmark if you're using active products, but that's one of those things that it's mathematically demonstrable. But the industry doesn't go out of its way to say that, because saying that explicitly would be bad for business. So that's part of the bullshit.

Pat Bolland 15:39
Yeah, but you're a portfolio manager, and you just gave your opinion on the market? And that's your opinion. You could be right, you could be wrong, right?

John DeGoey 15:47
That's right. So nobody knows. So then the question is one of how does one navigate? So there's, it's a two step processes, what's the asset mix going to be? And then what kind of products are going to use to build a portfolio? And so what I'm saying is I personally, speaking for myself, I'm trying to be as conservative as I can in the second half of 2023, because of all the reasons I just gave, and I use low cost broadly diversified products, and oftentimes things that are weakly and negatively correlated, in order to minimize risk. In its various shapes and forms. Are we talking

Pat Bolland 16:21
things like exchange traded funds, for instance, where the costs are so low?

John DeGoey 16:26
Yep. Right.

Pat Bolland 16:27
So you become an asset allocator, then, as opposed to a stock picker?

John DeGoey 16:33
That's correct. Yeah. I've never been a stock picker.

Pat Bolland 16:36
Wow. And how common How? How many investors take that kind of a track? How appealing is that kind of an approach?

John DeGoey 16:45

Well, this is now getting back to the Bullshift. So the industry wants to tell people that you can do better by engaging in active management. And statistically, it's improbable. But it's unambiguously more profitable for the industry, to use to get someone to pay for the trading and that you pay the execution costs, you pay the management fees, and various things like that. So there's a disconnect. Most people, including most advisors, as I mentioned earlier, believe in active management, and they believe it because they believe the story the will shift. But the evidence doesn't support it. But they don't want to look at the evidence, they would rather just Oh, but it's easier to sell something to a client, if I tell them how if the market does x, I can do x plus one or x plus one and a half percent by doing this, when an actual fact that it's much more likely that you will do x minus one or x minus one and a half as a direct result of doing that. So that's the jujitsu that the industry hasn't gotten its head around or refuses to get his head around. Because it's there's cognitive dissonance throughout the industry, because it doesn't want to deal with the dirty secret of the story they're telling their clients is one that is difficult to defend with actual evidence.

Pat Bolland 17:57
I don't know whether I understand that job because a lot of the mutual fund companies and the banks have got sure they've got active managers, no question about it, and portfolio managers that do that. But they also have very passive investment tools that are out there, ETFs and other things as well. So there, are they just playing both ends of the spectrum?

John DeGoey 18:16
So yes, that's correct. What the industry does is it says different strokes for different folks. And we're going to be product agnostic. Some people want active, some people want passive, some people want a combination. And we as a product manufacturer, you know, there are there are car manufacturers that have sports vehicles, they have compact cars, they have family sedans, they have luxury cars, the same the same car manufacturer will have different kinds of vehicles that they will manufacture, because they will have different products with different objectives. So it's the same sort of thing on the investment side, people will manufacture companies will manufacture products with all manner of different shapes, sizes, objectives, themes, variations, you name it. Okay,

Pat Bolland 18:59
but isn't that exactly what we started with? Advisors are not putting their clients into the right products. Isn't that their job, though?

John DeGoey 19:08
So yeah, the job is to find the products that are most likely to give a favorable outcome

Pat Bolland 19:13
and to shoot their investment profile their risks, right.

John DeGoey 19:16
And so if you've got, say, an actively managed Canadian equity fund versus a passively managed Canadian ETF, you know, then both of them will will meet the client's objective in terms of being I want some exposure to Canadian stocks. And we'll you know, I don't know maybe it's 25% of your total

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portfolio, I don't know. So on that level, they're apples and apples, and there's no difference. But if the difference in cost is let's say holding advisor compensation constant is 1%. Then all else being equal, you should expect the product that costs 1% less to return 1% more. In the words of John Bogle you get what you don't pay for. So the investment industry is the one industry where products product cost correlates negatively to product quality. If you're buying a suit, if you're buying a TV, if you're buying a car, generally speaking, the more expensive product is the better product is more quality, it's got better resale value, what have you. But on the investment side, the more product costs, the more that costs will eat into your return and less than less than at least for you as an investor or going forward. And that perverse difference in terms of what cost represents in the investment side, relative to what costs represents in virtually any other retail product is one that most people haven't really got their head around. And the industry is not really working that hard to disabuse people of the pre existing notion of everything else. If you're buying a computer, if you're buying a credenza, if you're buying a you know, a dress, always, you know, in all those other lines of endeavor, or fields of endeavor, the more expensive products are better. So that's what they want you to think for the investment products to

Pat Bolland 20:57
okay, how do we fix it? And one solution I read recently, and I want to say, as Warren Buffett, but I don't really remember who the big investor was. But when he first started out, he promised the people that invested with him that he would return them 6% and anything above 6%, he was going to keep 20% of that. So he had to have pretty spectacular performance. But he didn't get paid, unless he did perform. Is that a solution for the industry?

John DeGoey 21:28
Probably not. So why not? Think of it this way, but because the industry would go broke. So if you have a whatever the number is, it doesn't have to be 6%. It could even be 0%. If we have an industry, if we have a prolonged bear market, where markets go down for three years in a row, that would mean everyone in the business, all the companies, all the suppliers, all their staff, the managers, the executives, the sales reps, none of them would get paid for three years, because it just so happened out of happenstance that markets went down for three years in a row, they can go up for 20 years in a row after that doesn't matter. They'll be out of business because they wouldn't have any money to keep the lights on. Haven't gone down for three years in a row. So and that's even if

Pat Bolland 22:10
you don't think they'd follow their own medicine and say, Hey, we're in it for long term.

John DeGoey 22:15
Right? Well, I don't think they would be able to any business that doesn't have positive cash flow or doesn't have any kind of positive income. over a three year time period is unlikely to stay in business for year four.

Pat Bolland 22:28
Yeah, true. No easy fixes are there John?

John DeGoey 22:32

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No, no, there are not. John, great to chat. My pleasure, Pat all the best to you.

Pat Bolland 22:39
Thanks you too, John DeGoey, Portfolio Manager in Toronto. Thanks very much for joining us on this edition of The just word. I'm Pat Bolland. If you enjoyed it, subscribe, and remember, check out justwell financial. See you next time

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