Building Wealth Series Ep. 2 - Smart (Not Dumb) Investing

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SPEAKERS

Keith

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We are pleased to provide this text from our podcast. As you know, the spoken word is often less formal and sometimes less precise than a written piece that may be carefully edited. I have also been known to sometimes jumble my words beyond recognition! Please let us know if you have any questions or concerns -- and thank you for supporting the show! â€“ Keith DeGreen

K Keith 00:07

Welcome back. Thanks for joining me. I am Keith DeGreen. Now in part one of our building wealth series, we discussed all the not fun stuff we all really need to do before we begin to invest. Now finally, after we have paid off our credit card debt, set aside 10% of our disposable income to work for us built our cash reserves. And after some serious personal budgeting, we can finally get to the fun step making some money. So today's topic is smart, not dumb investing. Now the rules we will discuss apply whether you are investing in a retirement plan an IRA or within a taxable brokerage account. Now, let me issue the usual disclaimers. investing involves risk including the risk of losing your investment principle, results are never guaranteed, if you want guarantees by a federally insured CD, however, at the bank, you will usually earn less than the rate of inflation. And that's why we say that with a CD you are going broke safely. But at least you'll have your principal that way. Also, I encourage you to work with a qualified fee only investment advisor I was one for more than 35 years, I know of none better, I might add then my son Sam, with DeGreen allworth in Paradise Valley, a suburb of Phoenix, Arizona. And you can reach out to him, he's got his own web page on our website. Now, lately, with rates increasing CDs and other fixed rate investments, frankly, look more attractive relative to stocks than they have in years. But still, you will accomplish most of the growth in your portfolio by prudently investing in equities or stocks. Just one example. According to a recent article in the Wall Street Journal, if you had invested $100 In three month treasury bills way back in 1928, and kept rolling it over every 90 days, that $100 would have grown to $2,141 by the end of last year by the end of 2022. Now, if you had invested that $100 in medium grade corporate bonds back in 1928, it would have gotten grown to $46,379 by the end of last year, obviously better. But if you had invested that $100 In US stocks, that $100 would have grown to a whopping $624,534. So stocks are where your investment growth is likely to be over time. However, that does not mean you shouldn't have a mix of equities and fixed rate instruments in your portfolio that mix can reduce the short term volatility of your portfolio and give you some breathing room in years when equity markets refuse to cooperate. And we certainly had a few of those. Now, your stock and bond mix is generally determined by factors such as, for example, the income you require from your portfolio in retirement, your investment time horizon, your health, and your general willingness to accept some measure of volatility along the way. Remember, if you have a sufficient cash reserve, something we talked about in part one, that's the cache separate and apart from your investment portfolio, if you have that, then you will likely be more comfortable with the inevitable stock market fluctuations that occur along the way. And I encourage you to remember this. Volatility is just one type of market risk. Short term volatility is inevitable. The greater risk for most investors is purchasing power risk, the risk that what you have at what you've accumulated, will not be enough to sustain your standard of living in retirement. That's why it's important to prudently target portfolio growth that exceeds the rate of inflation over time. Now, one other distinction before we discuss what is in my opinion, the best, most prudent way to invest and incidentally, I have no dog in this hunt, no agenda with you. I'm retired from the investment advisory world. I just want to share with you what I've learned over several decades. Now. The distinction is this. Do not be a traitor, be an investor. One of the dark sides of investors of the investment industry is the perpetual attempts by broker dealers to encourage trading rather than invest Do you see the ads all the time? Use this trading platform or take this trading course. And you'll be smart and you'll be a smart trader. No. In fact, for the vast majority of people, there's no such thing as being a smart trader, when you go online to trade this or that stock, when you are in and out of a position based on your own can't fail system, or someone else's. You are competing with programmed high speed algorithms and against billions of dollars in institutional money, folks, you are cannon fodder for them? So why do all the major brokers promote trading to ordinary Americans, because although over time, you are almost certain to lose money, they make money on every single trade even if it's a zero commission to you, the securities being offered, give a piece to that broker dealers for having them on their platform. Now, if you truly wish to succeed in the market, you must and I do sincerely mean must be an investor and not a trader, a wise investor follows seven rules. First, they allocate their portfolio across asset classes and geographically to prudently spread their risk. Second, they diversify within each of the asset classes in which they invest. Third, while they never let the tax tail wag the dog, they do prudently harvest tax losses when they're available, and they use the most tax efficient investment vehicles. Fourth, they invest efficiently. Watch your expenses, the difference between an investment vehicle with an annual internal charge of say 25 basis points, that's one quarter of 1%. And a say a mutual fund that might charge you 1.25% annually, or an annuity with perhaps three to 4% of annual internal charges can add up the difference between those things can add up to 10s of 1000s of extra dollars to you over time, if you maintain a high level of efficiency. But don't be penny wise and pound foolish either. Over time, a good fee only advisor can add three to 4% of value annually not guaranteed. But that's the level of help that they can be not so much by picking the hottest stocks of the day. But by prudently obeying all the rules we're discussing here. And by counseling you to avoid boneheaded moves when markets get dicey. Fifth, the prudent investor invests long term, you know, Warren Buffett, arguably one of the most successful investors in history, likes to say that his favorite holding period is forever. For those of you old enough to remember, large portions of your portfolio should probably embrace the Ron Popeil infomercial slogan, set it and forget it. Six, the prudent investor invests for profit, that combination of dividends and capital appreciation that best produce results, they do not invest to prove some political point, or to pursue a political agenda. Once you make your money, you can spend it as you wish, but do not permit a money manager to signal their virtue with your money by making boneheaded investments in the politically correct industry of the day. And seven, the wise investor never makes changes to their portfolio based on short term market headlines, or based on their belief that the country is going to hell. A word on this seven point I know the country's going to hell, it's been going to hell since before I was born. And yet people make millions billions along the way. The job of your portfolio is to make you money, period, full stop, you know, in the 1700s way back then, economist Adam Smith describe what he called the invisible hand. That's the sum total of all decisions that are made by consumers in a free market as they each pursue their own enlightened self interest. Now, nothing has changed in that regard. Markets are entirely amoral. Market participants might be driven by the highest of ideals, or the lowest in the aggregate. It all comes out and balances out into Smith's invisible hand.

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factors today that mitigate toward continued market growth, despite shorter term fluctuations include not only the profitability of companies, because ultimately profits or projected profit growth, drive market valuations, but also the abundance of cash out there, compliments of the government deficits. We're going to be posting a nother podcast soon called the old New World Order. And in that we'll discuss the abundance of cash that is out there and its obvious effect on asset prices. So all that cash that is floating out there has to find a productive home. And historically, equities have not only been productive, they have been an effective hedge against inflation. For example, since the s&p 500 index was introduced in 1957, it has returned a 10% a 10.7% average compounded annual growth rate, including dividends, and in the past 10 years, it's returned 14.7% per year, on average. Both numbers are well above the country's historic rate of inflation, even after the inflationary spike we've seen in recent years. So do you really need to be trading stocks to achieve significant returns? No, you don't. And trading stocks is highly unlikely to produce those returns for you on a regular consistent year after year basis. Then, how best to access markets while observing those seven rules we just discussed. Hmm, I'm glad you asked a bit of history place. I sold my first investment advisory firm in 2006. While I was flunking retirement, I traveled extensively, including on my boat, the global adventure that we piloted across the Pacific. And I took a special interest in the world's emerging markets. I visited the BRICS, Brazil, Russia, India and China and a number of other emerging countries as well. I wrote a book called the emerging markets book. Now it's out of print now and its information is dated, but I sure learned a lot in the process of writing that book. Now during my failed retirement, I also examined how best to access emerging markets and other markets around the world. Specifically, I was interested in obtaining a as much diversification as possible as inexpensively as possible. I examined many mutual funds and many private investment programs, such as limited partnerships. Ultimately, it became clear to me that exchange traded funds ETFs offered the best path forward not just for investing in emerging markets No, but for also investing in the world's developed markets, including right here in the United States. You know, the first ETF, the s&p 500 Trust ticker SP y was launched in 1992. These guys are relatively recent, it's still SP y is still the largest ETF in the world, although there are other ETFs that now access the s&p 500 at less cost than spy back in 2007 and 2008. The ETF market hadn't still not really taken off. All that began to change after the 2008 financial crisis. And with my second firm degree in capital management, we led the charge toward ETFs. Our firm degree in capital management or DCM for short, was a fee only investment advisor that specialized in developing and managing portfolios. At very low cost using low cost diversified tax efficient liquid and transparent exchange traded funds. Why ETFs or mutual funds? Well, according to something called the Stiva report, SP iva, that's a report published by the s&p and Dow Jones index people, they publish it every year. According to that report. A an actively managed mutual funds consistently fail to outperform the very indices they choose to compete against. Stiva as I mentioned, stands for s&p inactive versus active. Now the report objectively it's been around for years object diddly covers all publicly offered mutual funds every year and compares their performance not only to each other, but to the indices against which they compete. That the performance of actively managed mutual funds has been terrible is not just a one off accusation based only on a single year, I'm talking about year after year after year, where 70 to 90% of actively managed mutual funds fail to outperform the index they claim to compete against. Meanwhile, they charge more, they are less tax efficient, and they are less liquid than exchange traded funds. And there is only a 4% chance of a mutual fund that finishes a year in the top quartile of its peers remaining in that top quartile for five years 4%. In fact, one of the best ways to lose money as an investor is to invest in last year's top performing mutual fund. years ago, mutual funds were their pretty great idea, investors did not have the online access to company information that is commonly available today. So mutual fund managers would and still do essentially sit around a table with their Weegee boards. And Devine which stocks or bonds in an index would outperform the index and which stocks or bonds in that index would lag. They then did and do overweight, their perceived winners and underweight the losers in the index. Problem is, that doesn't work. With the flood of information out there today, available to institutions and individuals alike, markets have become incredibly efficient. Year after year, this bhiva survey results objectively illustrate that there is just no profit in trying to outsmart the indices. Now, regarding taxation, mutual funds must pass all gains on to their shareholders by the end of each year. So if for example, you buy a mutual fund in say June, that has already posted again during the first five months of the year. And then if the fund takes the rest of the year, congratulations, you will still get a tax bill for the gains that occurred in the fund that year before you even bought it. Now with ETFs, your tax basis is your actual cost. Overall, they're much more tax efficient than mutual funds. Now regarding liquidity,

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you may only trade a mutual fund at the end of a trading day. So if markets tank or you have an emergency, and you need to liquidate your position immediately, regardless how early in the morning, you enter your order, your mutual fund will not cash you out until the end of the day at its end of the day value. So you can literally spend the day watching your value deteriorate if there's a major sell off. Meanwhile, index tracking ETFs trade just like stocks, you can get in and out in a heartbeat during the trading day. Now, what is an index anyway? An index is just a list of stocks or bonds or other investments. Whoever makes the list decides what the percentage allocation will be of each position in the index. And how that percentage will be calculated. Will the index be cap weighted? Based on the value of the outstanding shares of each company? Will it be equal weighted? Or will it be something else? All that is made public. So an index is not really an investment. It's just a list. And ETF, on the other hand throughout each trading day uses market makers to buy, sell and track the components of that index to reflect the aggregate value of the index in the real world and in accordance with the weightings designated by the index provider. The ETFs job is to accurately reflect the aggregate value of the components of the index in their exact percentages. Now that value is known as the net asset value or nav for short. And ETFs job is not to outperformance index but to act generally reflect the value of the index at any given moment. If there's a lot of interest in an ETF, or if there's too little interest in an ETF, it might temporarily traded very slightly above or below its NAV, its net asset value. But this is typically not that common or significant. Now, there are now more than 5000, exchange traded funds, products that are out there on major exchanges. And they have become by far the most popular investment vehicle in America. And there are hundreds of indices. Sure, the most widely known are the Dow, that's the Dow Jones Industrial Average, which is not technically it's not an average and it's not industrial anymore. It's a lot of different things. Then anyway, the index and that's the Dow is the index of 30. Giant US companies, the s&p 500, another index, very well known, and the NASDAQ composite. Interestingly, the most popular NASDAQ related ETF, triple Q or Q QQ only tracks the 100 largest companies on the NASDAQ exchange. Now those companies tend to be tech companies, but not exclusively. Now. To add to the confusion, a stock in the s&p 500 is often also in say, the NASDAQ 100, or even in the Dow. That's why you need to look under the hood as you invest in ETFs to make sure you are not duplicating your efforts. For example, if I invest in ETFs, that track say the Dow, the s&p 500, and the NASDAQ. And if I buy an ETF that tracks a technology, I will be buying Apple Apple computers, the company for different times overweighting that or any stock may not be prudent, depending on your situation. Now, this is just one of the many reasons I recommend you do work with a qualified fee only investment advisor who specializes in the management of balanced ETF portfolios, it can be well worth their fee, also, and um, you know, after I retire, I'm very proud of the fact that Sam continued that tradition in our office. And that's that's all he does. And he's good to. Also please note, unfortunately, many of those 5000, so called ETFs that are out there on the market these days are just actively managed mutual funds in disguise. So you need to be careful, but the best ETFs are entirely passive. That is they only track the aggregate performance of their index. And they charge only a tiny fraction of a percent annually. While they faithfully track the index that they represent, you know, at DCM Green Capital Management, before I sold it, the let's see, I completed the sale in late 2022. At that time, our average portfolio, ETF cost was only 22 basis points, or 22, one hundredths of 1%. And keep in mind that our DCM portfolios included geographically diversified ETFs for markets around the world, which tend to be a bit more expensive to access. So many mutual funds still charge more than 1% per year for results that do not keep up with the indices against which they compete. Now I know what you might be thinking, hey, you say if I had just owned Apple, or Amazon or nividia, I would have had, I would have way outperform the market. True. But here's the thing. If you own an ETF that tracks the indices that include those companies, guess what? You also own those companies. You just own them in proportion to the market overall. A much safer way to go. Now just ask the folks who are entirely in tech back in 2001 when the NASDAQ imploded. And look at that it took more than 14 years to recover. I'll never forget, we had an elderly woman who was a widow as a client. And she marched into my office one day in December of 2000. And said, I'm firing you right now. And she did she fired us. But I said Why should because you won't put me in more tech. Everybody's making money in tech. This was an elderly woman who was a widow. Within a month, I assume that she went out and did herself damage and when loaded up just on tech within a month, NASDAQ was in the process of losing 40% of its value. Diversify, diversify, diversify. Now, you might wonder why some advisors still recommend mutual funds over ETFs? Well, typically, it's because those funds pay commissions, including sneaky back end commissions called 12. b1 fees ETFs do not pay commissions. This is another reason why I recommend you work with a fee only investment advisor who has no secret agenda, no axe to grind. Now how best to construct an ETF portfolio? Hmm, that's a good question. Well, first, you'll be lucky if ETFs are offered in your 401 K plan at work. Some plans are offering them now but too many still don't. If your plan does not include a selection of broad based, inexpensive ETFs raise health plan sponsors have a fiduciary duty to keep expenses down and investment selections

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reasonable. They can satisfy both requirements by offering ETFs. Now, in constructing your portfolio, it's important to note something called geographic bias, it probably will not surprise you to know that people in various countries tend to invest heavily in companies that are listed on the exchanges of those countries. Well, we do the same thing here in the United States. But should we? Actually, yes, US markets are the most vibrant, transparent, and in recent years, by far the most profitable markets in the world. But you should also not shy away from creating some geographic diversity in your portfolio. You know, our portfolios typically included approximately a 10 to 15% allocation, and could have even been less than that maybe eight to 12% allocation to other developed markets, and a six to 10% allocation to emerging markets. The rest stayed right here in the good old USA Bay. And yes, you do get some vicarious exposure to other world markets, especially when you invest in us large cap companies, because many of them have foreign operations. Now perhaps the greater question is whether and to what extent you should allocate part of your portfolio to fixed income indices. Yes, there are many fixed income or bond indices. Technically, a fixed income investment, where the maturity of more than 10 years is a bond. Anything less is either a note or a bill. But I'll use the word bond here generically to mean all fixed rate investments. Now many countries issue dollar denominated bonds. This is helpful as it avoids currency risks, that's the possibility that a bond denominated in a foreign currency might decline in value, because the currency declines relative to the US dollar. And of course, there are many US and non US major corporations, good companies that issue bonds, notes and bills, as well as does the largest debtor on Earth, the United States government. Yes, there is a dark side to so called Safe government debt. And we're going to talk more about this in the old podcasts, the old New World Order. So I do hope you tune into that one as well. Anyway, there is a dark side to all this so called Safe government debt, certain government programs are off the table, you know, Social Security, Medicare, et cetera. Those are non discretionary items in our in our federal budget. Now, of course, we also allocate funds for defense, the rest falls into what's known as discretionary spending. The interest expense on our national debt consumes three quarters of discretionary non defense spending. At the current trajectory, our interest expense will consume 100% of our discretionary non defense spending by 2031. And that's according to the Office of Management and Budget. That's 100% boom, gone. Fitch rating services recently downgraded the US debt for the first time since 2011. Now most analysts consider this a non event, but the numbers are far worse now than they were then. It's virtually impossible for the US dollar The world's reserve currency to actually default, but rates can increase as worldwide investors demand a greater return on their US dollar investments. On the other hand, when compared to other countries, the US dollar remains pretty much the cleanest dirty shirt in the pile. Go figure. Now, regardless, there are many, many fixed income ETFs out there, and don't just shop for yield. However it is, because that's a dangerous game, it's very important to measure the credit quality of fixed income ETFs. Now some risk is okay, if it is widely diversified, but low rated and subprime debt can collapse like a house of cards, as we all saw during the 2008 meltdown, so settle for a reasonable rate of return with decent aggregate credit quality that is well diversified. This is definitely a discussion I would recommend you have with your advisor. Now, the final question to address is, is this what percentage of your portfolio should you allocate toward equities stocks? And what percentage should you allocate to fixed income bonds? The answer is, I don't know. I don't know. Now that rates have risen, fixed income looks more attractive than it has in years. On the other hand, if you have a substantial cash reserve outside of your investment portfolio, and if you are investing for the long term, perhaps a very large portion of your portfolio should be allocated toward diversified equities. It is your personal situation, and not some arbitrary formula that should drive your allocation decisions. I will say that using ETFs greatly enhances your ability to prudently diversify across all asset classes, including all variations of stocks, and bonds. Now, the old formula that you should have 10% of your portfolio in fixed income for every decade of your life, for example, 60% in fixed income, if you're in your 60s, that old rule is in my opinion, just dumb. Dumb, that's dumb investing. Maybe you need more, maybe less. Your allocation must be based on your personal situation, on your goals, on your risk tolerance on your health, and on a dozen other factors. do have that candid conversation with your objective fee only advisor, you'll be glad you did. Now, after decades of experience in the investment industry, I am convinced that you can build substantial wealth, not with homeruns but with singles and the occasional double gradually with discipline, one run at a time. You can do it. Thanks for joining me today. I am Keith DeGreen. And this is as I SEA it!

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