KEEN ON
RETIREMENT

Which is Better—Passive or Active Investing? Yes!

Welcome to Keen on Retirement
With Bill Keen and Steve Sanduski

Steve Sanduski:	Hello, everybody. And welcome back to Keen On Retirement. I'm your cohost Steve Sanduski. And here with me on this chilly day is Bill Keen and Matt Wilson. Hey guys, how you doing today?
Bill Keen:	We're good today, Steve. How are you doing?
Steve Sanduski:	Fantastic. Yep. It's always good to chat with you guys on a new episode of Keen On Retirement. So, we've got another fun topic here today. But Matt, do you have something you're going to challenge us with as we get started?
Matt Wilson:	I'm always a fan of history. And we had something very exciting happen in January 10 years ago. Any guesses? I'll give you some-
Bill Keen:	Leaves it wide open there-
Matt Wilson:	You know, maybe you can give me some high-level guesses, we'll narrow it down from there.
Bill Keen:	What do we get a hint is what I would ask.
Matt Wilson:	No.
Steve Sanduski:	How about-
Matt Wilson:	I've got to think of a hint that doesn't give it away.
Steve Sanduski:	How about we do this …? How about Bill and I each get to ask you two questions and you can say yes or no.

Matt Wilson: Okay.

Steve Sanduski: So, my first question is, is it financial related?

Matt Wilson: No.

Bill Keen: Is it politics related?

Matt Wilson: No.

Steve Sanduski: Is it geopolitical related?

Matt Wilson: Hmm, it is not.

Bill Keen: Does it have to do with the birth of something or someone?

Matt Wilson: No. I don't think those questions are very-

Steve Sanduski: Were very helpful.

Matt Wilson: … were very indicated. So, here's the hint.

Steve Sanduski: I guess we're not good at that game.

Bill Keen: Yeah, I know, pretty poor questions there.

Matt Wilson: This hint, maybe it's still a little bit vague, it has to do with aviation.

Bill Keen: Oh, okay.

Steve Sanduski: Well, Bill, that's right up your angle there.

Bill Keen: Yeah, I started taking flight lessons in 2010. So, that would have been … No.

Matt Wilson: No.

Bill Keen: That's probably not it.

Matt Wilson: No. I don't think that would have made the website.

Bill Keen: Nobody's really that interested in that. Okay. Why don't you …?

Matt Wilson: Yeah, so here it …

Bill Keen: Wait, wait, hold on.

Matt Wilson: Okay.

Bill Keen: Does it have to do with the Hudson?

Matt Wilson: It does.

Bill Keen: Sully Sullenberger.

Matt Wilson: Yeah. US Airways Flight 1549, it was the most successful ditching in aviation history called the Miracle on the Hudson. Mid-January 2009.

Bill Keen: Well, it's interesting you bring that up because multiple times we talked about how fast time goes by, yeah, 10 years since Sully successfully ditched in the Hudson, it's amazing how quickly time passes. But wow, what a story, huh?

Matt Wilson: Yeah. Interesting. Flying into that flock of geese and losing all power …

Bill Keen: Both engines.

Matt Wilson: Yeah.

Bill Keen: Amazing. We saw him speak, didn't we, Matt?

Matt Wilson: We did.

Bill Keen: Probably when a couple years after it happened, didn't we?

Matt Wilson: Yeah, it was maybe five, five or six years after. It was at the actual Smithsonian Aviation Museum where we saw him speak, yeah, they played the radio call and everything.

Bill Keen: Oh, sure. Sure. They did the movie on that, it speaks to training, it speaks to pre commitment to what happens when things don't go your way. He spent a lot of time on the simulators. But they tried to tell him that the computers said that the airplane should have been able to make it back, I believe to the airport.

And he said you have to give a human a couple of seconds to troubleshoot and determine what the next best action would be. And it was those couple seconds that would have not allowed them to make it back to the airport.

Matt Wilson: And even the aviation board that investigated it said that it wasn't going to be possible after the fact, they said it wouldn't have been possible for them to go back.

Bill Keen: Okay, okay.

Matt Wilson: Based on that analysis, I would say they probably did the best, absolute best thing they could have done because if they tried to go back I'm sure they would have landed on the ground.

Bill Keen: Right. For sure. Yeah. Wouldn't have been the-

Matt Wilson: In the city.

Bill Keen: … landing, probably, as we like to say.

Matt Wilson: I think what's interesting too, talking about checklists and aviation and following a set of rules, because that's really what the checklist is it just written down in front of you. And recently, the founder of Vanguard passed away. That was John Bogle and, he is credited with inventing the first index fund, and we're going to talk about that today, what is an index fund? But really, from the highest level, an index fund is just a rules based approach to investing. That's all it is.

Bill Keen: Sure.

Matt Wilson: There are many indexes out there in existence. But he is credited with starting the very first index fund and he was 89, I believe-

Bill Keen: When he passed.

Matt Wilson: … he passed. And it was just a couple weeks ago.

Bill Keen: You know, he was considered probably one the best investors of all times, but really one of the true innovators, I think, in the industry as well.

Matt Wilson: Yeah. He started the Vanguard, a company in 1974, and their very first product, so to speak, was a mutual fund that tracked the S&P 500. So, prior to this fund being accepted, there was no way for, especially for an individual investor or what's commonly referred to as a retail investor to monitor or track the S&P 500, because there's 500 companies in there and you'd have to own every single one of them and all the same weights and everything that the S&P index was calculated. So, he created a fund to do that for you.

Bill Keen: Well, for the small investor, it would have been impossible too. I mean, so the whole mutual fund could not accept or this being able to buy into some sort of a pool of investment allowed the smaller investor to get started building wealth in the capital markets.

Matt Wilson: Yeah probably the big difference between what John setup was this index fund that track the S&P 500 and big difference between and American century was it was considered passive. It was not an actively managed fund in the sense that there was an investment team and investment committee making buying sell decisions within that fund. Instead, what the Vanguard Fund did was it just follow the rules that the S&P Index had us to create an index. So, there was nobody that needed to actively manage it.

Now, talking about index funds and passive investing, that's the big example. It's probably the 800-pound gorilla, the S&P 500, it's easy to track and see, the media here in the United States puts it in front of our faces basically every single day, especially the financial media, but there's another Index Provider called the Dow Jones, they create the Dow Jones index. But the Dow Jones company has 130,000 indexes-

Bill Keen: I was just going to ask you …

Matt Wilson: … that they've created.

Bill Keen: When someone comes in and says, "Well, we're considering indexing." The first question we would have, and we're not against indexes. And we can talk more about how we actually use these, in our process, but the question is indexing, okay, which index? And then what allocations, and then how often and when do you rebalance these indexes? And then just understanding what the risks are associated. So, the risk being the downside volatility in difficult times, because we know and research has shown and our experience has shown that the best investment program for someone is one that they can stick to, and we know that Steve we're going to be having Dr. Daniel Crosby on the show here in a few episodes, he's a behavioral psychologist.

And I think it's so important we talk about the behavior and the psychology around investing. Because if you owned the S&P 500, and that was your entire investment back in 2001 and 2002, or '08 and '09, you saw half your money go away. And the news press telling you that that was just getting started, right? It was going to go on down from there. And a lot of people that we're implementing those types of strategies, unfortunately, sold out and they were seven figure mistakes. So, for someone who has the wherewithal to potentially just say, "We're going to go all in and leave it alone and not look at it," it might work, what we found in the world of emotion and human behavior is diversity, rebalancing, understanding when you might need some of this money back, if you're living on the proceeds. It complicates things, doesn't it?

Matt Wilson: Mm-hmm.

Bill Keen: With the proceeds simplicity of just owning an index, as they say.

Matt Wilson: That's right. Yeah. And the index funds, they have a set of rules that they follow, and those rules can lead to over waiting in certain asset classes or certain sectors of the market the S&P is made up of 10 sectors and those sectors represent the 500 largest companies in the United States. They do business all over the world, but they're headquartered here in the United States. And it waits the individual holdings by what's called their market capitalization.

Bill Keen: Yes.

Matt Wilson: The market capitalization is just their share price times their shares outstanding.

Bill Keen: Okay.

Matt Wilson: So it's roughly to say, how big is the company?

Bill Keen: So, the bigger the company, the more, from evaluation standpoint, based on the formula you just shared, the more of a percentage it will make up of the S&P 500 Index?

Matt Wilson: That's right.

Bill Keen: So you know my next natural question is, how much of the S&P 500 is Google, Amazon, Netflix, that kind of thing. So, we think we're in a diversified portfolio and we realize we have, what's the number, right? Do you know?

Matt Wilson: Well, it is diversified because it does have those 10 sectors, but again, yeah, weighted by the size of the company. Now, one thing you might have caught on is I didn't say how profitable that companies are, how much revenue they make, what's the earnings per share, those aren't part of the market cap waiting? Now, essentially, you might say it's part of the stock price, but it's just shares outstanding times the price of the stock.

Bill Keen: Right. Are you saying the markets might be irrational at times?

Matt Wilson: Well, the index is going to factor that in, because in the late 90s, this was the issue with the index funds, as they were very heavy in the tech sector.

Bill Keen: Yes.

Matt Wilson: And it was with those companies that were very large, but maybe didn't have very good earnings, or any earnings. And those companies took a big hit, and the NASDAQ, which is another index that tracks more of the tech sector was down 80% the S&P 500, because it is a little bit more diversified was only down 50, in 2000, through ‘02.

Bill Keen: Closer to 60, and then '08, '09.

Matt Wilson: And then '08, '09, it was almost 60% from the peak down to the trough. And again, that was part of just the overall market and everything that was happening there. But, yeah, the weightings within the sectors can get out of whack. So technology, again is the biggest sector, and as it was back in the late ‘90s. Now, one big difference today is the tech sector is way more profitable today than it was back then. Not to say that being overweight the tech sector is a good thing. But there is at least a lot more rationale behind those weightings at least in terms of the investing public because these companies are very profitable.

Steve Sanduski: So Matt, I think one of the interesting things about a market capitalization weighted index, like the S&P 500 is that companies that are really large companies like Apple and Microsoft and Amazon that they make up a significant percentage of the value of the index. And so, even though, it's just a small number of companies, they have a disproportionate impact on the return of the index. Do you happen to have any of those numbers at your fingertips that got to show the disparity there?

Matt Wilson: I do. The top three stocks in the S&P 500 make up nearly 10% of the weighting of the portfolio.

Bill Keen: Did you say three?

Matt Wilson: Three stocks and that's Microsoft, Apple and Amazon.

Bill Keen: Okay.

Matt Wilson: So, those are going to have a disproportionate waiting or impact on the value of the index based on what their performances over short periods of time. Now, over long periods of time they will assuming nothing changes. Now, what happens over time is yes, other companies become larger, and they may knock down some of these companies like Microsoft, as we mentioned, one of our previous podcast, biggest company in the world in late 90s dropped 60%. And other companies replaced it like GE at one point. So, it does cycle from in and out of favor. Now, if you look at the top 25 Holdings, that makes up 35% of the index.

Steve Sanduski: So, I think another way to look at that then is you may think that you're getting the performance of 500 stocks, which technically you are, but a very small percentage of the biggest companies account for a substantial percentage of the return of the S&P 500. So they're not equally weighted, which would be the alternative where everyone accounts for the same percentage in the index.

Matt Wilson: That's right. Yeah, and there are there's been a lot of expansion among these types of, of just indexes in general, this is a traditional market cap weighted index with the S&P 500. And then there's been a big explosion of indexes that are some of them are what would we call evidence based. So, they're using factors like value which does take into consideration well what the company earns. Let's weight the index based on an earnings or let's wait them based on dividends or even as Steve, you just mentioned let's equal weight all 500 of them.

Steve Sanduski: Sure.

Matt Wilson: There's an equal weight S&P 500 Index.

Bill Keen: So now, that's basically active management, right? I mean now we're-

Matt Wilson: You're still having the same rules based approach, but you now you're shifting from just this pure passive, in that sense of like what the traditional S&P 500 is, and you know, even us at Keen Wealth, I mean, we do believe there's a balance between the active and passive components to a portfolio because, owning the S&P 500 is going to be good at times and other times it's not going to be as well as other asset classes. And so, you want to own that may be in the component of a diversified portfolio.

But also there's international indexes. There's emerging market indexes, there are small cap indexes, mid cap indexes, there's indexes that by fixed income, but you also when you own this the index like the S&P 500, your own good companies and, maybe bad companies, however, you wanted to find that, we would say companies that maybe aren't as shareholder friendly, they don't have as high quality earnings is other companies, they're not good capital allocators. They might be actually destroying shareholder value by issuing a lot of shares and issuing a lot of debt, which the index doesn't screen for. It just owns them all.

We like to take an active approach in that sense, where we want to focus on companies that are more shareholder friendly, that are doing things that are in someone's best interest, like paying a dividend, buying back shares, reducing debt, not issuing a bunch of shares, not purchasing a bunch of other companies. And we feel that that adds value to the portfolios over time.

Matt Wilson: And then there's even the process of actively managing the passive indexes and that process, as you alluded to earlier, okay. Which asset classes do we own? According to Dow Jones, they've got over 130,000 indexes, so which ones of those do we own? Then there's what weights then. So okay, now we've narrowed it down. Let's say we've narrowed it down to 20. Now, what percentage do we put in each one?

Bill Keen: For sure.

Matt Wilson: And that can be unique to each individual based on their risk tolerance? And how much income do they need from the portfolio? When do they need this money back? I mean, that's all going to factor in the weightings. And also taking to consider consideration volatility too because, as you said, the best investment strategies, the one you can stick to, and we go over this chart in our meetings where we look at just, maybe the top 10 asset classes and look back at how they did the last 15 years. And the number one performing asset class is also the most volatile.

Bill Keen: Right. Emerging markets, right?

Matt Wilson: Actually, this year it was real estate.

Bill Keen: Real estate.

Matt Wilson: Yeah, emerging market’s number two.

Bill Keen: So, we don't want to put all our money in those but they did the best, right?

Matt Wilson: If you had the ability to one know what was going to happen in the future and then never look at your statements for 15 years. Yeah, that can work. But since we don't know the future and …

Bill Keen: We’re not recommending that.

Matt Wilson: No. We are not.

Bill Keen: Okay. Okay. I said in my freshman level, believe it's freshman level investment course, or economics course, and in college probably 30 years ago. And we started learning about passive investments, like we're talking about with indexing and active, passive versus active. We also talked about technical analysis versus fundamental analysis. And it was interesting, it was almost like politics, right? There were hard line folks on either side of those aisles. It was either passive or active. It was either fundamental analysis or technical analysis. And even back then, very inexperienced, although I had been trading in the market since I was in high school.

Steve Sanduski: Yeah.

Bill Keen: I had a Schwab account in 1985. My parents had to be on it with me because I wasn't I was not 18 yet.

Matt Wilson: Did you talk to Chuck directly?

Bill Keen: I didn't. I tried to reach him but he was pretty busy back then still, now that we have relationship with Schwab here at Keen Wealth, we still haven't been able to reach him.

Matt Wilson: No.

Bill Keen: We've gotten pretty high up the ladder, but I remember trading options or derivative securities on IBM back when I was in high school, or sophomore in high school just to understand, it wasn't a lot of money involved but it was giving me a really interesting understanding of how the capital markets work and derivative securities, leverage and those kind of things back then. But I remember the crash of ‘87, and now, I'm diverting, sorry, I'm diverting our talk here. But I remember the crash of ’87, I can tell you where I was. It's crazy. It's almost like you know where you were when 9/11 happened, it's probably a bad comparison. But I remember where I was that evening on the campus as a freshman

October of ‘87, and I was trying to get ahold of Schwab to place an order for my not very large account, but I think it was four digits, my account, I think I had over 1,000 in there. And I was trying to get ahold of them. I knew the market was probably an open way up or way down. And guess what happened when I tried to reach them?

Matt Wilson: You couldn't get hold of them.

Bill Keen: Line was busy. The line was busy, Steve.

Matt Wilson: Back in the payphone days?

Bill Keen: Back in the-

Steve Sanduski: Yeah. Well, thanks for a little different back then, for sure.

Bill Keen: I was calling from a landline, but to land this plane, so to speak, it’s understanding that in my common sense view of things, it doesn't have to be all, technical or fundamental. It can be both. Why don't we look at things technically? And also fundamentally, does it have to be all passive are all active, why don't we look at both? Why don't we say let's use the best of both in and put that into play in a way that can make sense.

Matt Wilson: Yeah, that's right. I mean, it's all about … Because they both have an active process and a passive process, both have very good qualities, and if putting them together helps the portfolio to be more diversified, help reduce volatility, that's exactly what we want. And going back to that chart, I mentioned that we look at the top asset classes. Well, one thing that we also look at is what a diversified portfolio does and with an active management wrapper around it, of rebalancing the portfolio on an annual basis. It gives us what's the free lunch, so to speak, in investing where we're able to increase the rate of return and reduce the risk, to reduce the volatility. It's never in the purpose of a diversified portfolio, it is never to be the best performer that year, but it's also to not be the worst performer.

Bill Keen: Right. A diversified portfolio will never be the best in any given year.

Matt Wilson: That's right.

Bill Keen: Compared to any one class. We know that for sure. But to your point, it's not going to blow somebody's retirement up.

Matt Wilson: That's right. Yeah.

Steve Sanduski: And Bill, I want to go back to something you said here just a minute ago and you said that, why be all passive, or why be all active? You want to take the best of both. And I think that's a really important point, because what I see out there is that you've got some people who are just totally dogmatic, and they say, “It has to be 100% passive, or it has to be 100% active,” and they let their ego get in the way instead of what you guys do, which is you look at the information, you look at the research, you look at history, and then you decide what is going to work best.

And so, you take the best of both. So, it's not an either or, it's an end. And so I think it's great that you're able to get the ego out of there and do what you think is best based on what the research says and what is best for clients. So, I think that's an important point that we need to make here.

Bill Keen: Well, thank you, Steve. I can speak from now 27 years of actual doing this in real world with real clients and assets, my own experience and it says, what's going to get the job done for folks with attempting to have the least amount of stress and strain and anxiety. And then and then how do we employ a process and a strategy that's disciplined, that's repeatable, and that folks can understand why they're doing what they're doing. And I think that's a huge part of it, because we always come back to this behavioral side of things, too. So, there's this dance between what is technically the, quote, best investment and then what is the investment that gets a family to their destination.

And I just believe that for a client to be successful long term that we don't have to make them financial planners or Chartered Financial Analysts or CPA or any those things, but I do believe they have to understand why we're doing what we're doing. And that's why the planning process is so important, because today we're just talking about the engine to the plan, the investments, but in most of our podcasts, we talked about the why and the why is the plan and it's around taxes. It's around spending levels. It's around making sure that healthcare coverages are provided.It's all those things, wills and trusts that go into the plan and really understanding someone's why.

The investment part of it is just the engine to the plan. I always like to go back to that. And we do believe, don't we, Matt? That indexes, we use probably over 20 different indexes in our portfolios, but we also use individual securities. We don't just default to outsourcing the money management to mutual fund managers and hoping it works out.

We have a very disciplined repeatable process that we're able to say, what indexes should a client be in and then what securities typically it's around 50 securities-

Matt Wilson: That''s right.

Bill Keen: … individual securities as well if someone has the asset based to be able to diversify appropriately.

Matt Wilson: That's right. And I need you to tie back to John Bogle, the founder of Vanguard, he also believed in active management.

Bill Keen: Sure.

Matt Wilson: Today, two-thirds of Vanguard funds are actively managed.

Bill Keen: That's interesting-

Matt Wilson: So, the creator of the Index Fund, the father of passive of investing it so to speak, has two-thirds of his company actively managing investments.

Bill Keen: So, maybe he thought that the best of both worlds can exist as well.

Matt Wilson: That's right. That's right. It's not an either or, but a both, and.

Bill Keen: That's right. And it's always easy for folks that either aren't doing this for real, that are just making comments about it online or making-

Matt Wilson: That's right.

Bill Keen: … maybe on Fox Business or something to look backwards and say, “Oh, my goodness, look at this thing did the best last 10 years. And this is where you should have been.” I mean, it's such a fantasy, is it?

Matt Wilson: That's right, especially when you take it out of context. Well, how did that investment get to where it's at? How volatile was it? And part of that that graphic that I keep mentioning is we point out to people, yes, some of the best asset classes are also the ones that will be the best one year and the very worst the next year. And it's easy to look back and say you would have stuck with it, but I can tell you living through those things, there's very few people that can actually stick to that volatility of those swings when they happen.

Bill Keen: Oh, sure.

Steve Sanduski: Well, guys, I just want you to put me in the top asset class each year.

Matt Wilson: Okay.

Steve Sanduski: Can you read for me?

Bill Keen: You have an inside line to it here, Steve. There's some program we could offer you.

Steve Sanduski: Yeah, if it were only that easy, right.

Bill Keen: Right.

Matt Wilson: Well, getting our DeLorean and go back with Marty McFly.

Steve Sanduski: What was it?

Matt Wilson: The market history.

Steve Sanduski: So, it's kind of like that old saying that I think is attributed to Will Rogers. He said something to the effect of, “Yeah, I just want to invest in things that are going to go up, and if they don't go up, then I'm not going to invest in them.”

Matt Wilson: Excellent. It sounds like a good strategy.

Steve Sanduski: That's right. All right.

Bill Keen: Vanguard did come out with a piece a couple years ago, and did say that they believe that by working with an advisor that is helping you with a number of different things that it could add up to 3% net return.

They call it total potential value added. But here are the here are the places where advisors help clients, suitable asset allocation using broadly diversified investments, rebalancing, understanding, we mentioned that earlier knowing when to be what sectors to be in and when to rebalance them. Asset allocation in general, how much in stocks and how much in bonds and then all the asset classes Matt mentioned, a spending strategy, so coaching on the order in the places to take money from first, which would also be a tech strategy as well. Total return versus income investing and then behavioral coaching. It does come down to that, this is for Vanguard, now. This isn't me, this is Vanguard, and then finally, cost effective implementation. So, maybe not just using high price mutual funds and folks charging a fee on top of that or somebody charging, commissions.

Matt Wilson: Commissions, yeah, the first sales charges.

Bill Keen: That kind of thing. But all that combined, Vanguard themselves comes out and says that, that could, potential value added could be 3% a year for those services from a qualified advisor and I would say, fiduciary advisor.

Steve Sanduski: Yeah, that might be an episode all by itself down the road as well. Just really what is the value that a financial advisor offers, and we've got a lot of good things we could talk about there. Well, hey, guys, let me just quickly wrap here. So what I gathered today, basically, three things, that when it comes to all of our listeners who want to get their financial situation in good order, three things we need to do. One is we need to have the right investments, we've talked about those today. Could be passive, could be active, could be individual securities.

Of course, we want everything to be diversified as well. Second is we need to get the right plan. So the importance of the financial planning process. And then third is the right behavior. And we'll have an episode coming up here, as you mentioned earlier, Bill with Daniel Crosby, one of the country's foremost experts on behavioral psychology as it relates to financial investing. So yeah, so I think might be a little summary there. And any final words that either of you want to add, as we wrap up today.

Bill Keen: I know we talked a lot today about different indexes and maybe some things that were a little more technical.

At the end of the day, we just want to provide an environment where folks can learn and have the best opportunity to manage a successful life all the way out through retirement. So, appreciate your taking the time again today, Steve, always enjoyed the episodes and I look forward to our next one. Matt, thank you.

Matt Wilson: Okay, thank you.

Steve Sanduski: Well, thanks, guys. And for all the information we've talked about today. And all the past episodes you can go to keenonretirement.com, that's K-E-E-N-onretirement.com. Guys, look forward to the next conversation. And between now and then, stay warm.

Bill Keen: You too.

Matt Wilson: All right.