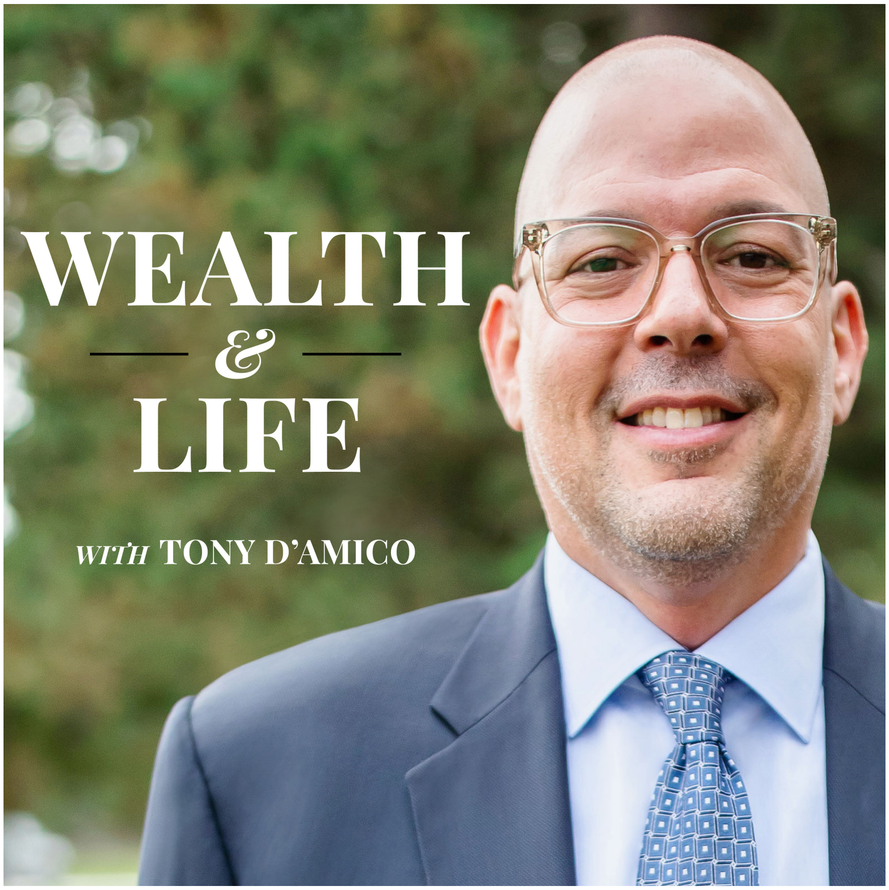
Ep #07: Investing for Long-Term Success with Christian Newton



Full Episode Transcript

With Your Host

Tony D'Amico

Wealth and Life **with Tony D'Amico**

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Welcome to *Wealth and Life*, where you'll learn with financial planner, consultant, speaker, and business owner, Tony D'Amico. You'll hear stories from successful business owners and individuals about how they navigated the inevitable challenges that arose as they achieved each new level of success, and you'll get insights and strategies from leading wealth planning professionals on how to achieve your next level of success. Now here's your host, Tony D'Amico.

Tony D'Amico: Well Christian, welcome to the Wealth and Life Podcast, really excited to have you on today. And to our guests, Christian Newton is a Vice President at Dimensional Fund Advisors, part of their global client group. Has been there for 17 years. I've had several different roles, worked in several of their different offices and plays a really key role in really working with financial advisory firms out there to share about Dimensional and what they do, and their investment philosophy. So, super excited to have you on today Christian.

Also, just a little bit about Dimensional for our listeners before we jump in. Dimensional Fund Advisors has been around for almost 40 years, and they've been working with advisors for about 30 years. You guys manage about 500 billion in assets, so about a half a trillion in assets. Other really interesting points too, over a 20 year period while most equity and fixed income funds only 17% of them outperform their benchmarks, with you guys a little over 80% of your funds do better than their benchmark.

And again, really pumped to get into this, because obviously you guys are a top notch institutional investment manager and we really appreciate the partnership and obviously, we use your funds for a portion of our portfolios. I think the other thing too to throw out about you guys is that there's about 300,000 registered advisors in the country and you guys work with less than 5,000 of them. A little less than 2% of the advisor population. I think that's really great and I guess Christian to kick things off, again welcome. So, why does Dimensional ... Why is Dimensional so selective on the advisory firms that they work with?

Christian Newton: Well, I'm sure your numbers are right so there is clearly a selection activity happening there. Not to be contrary just coming off the bat because I really appreciate your introduction, all accurate, but I think it's not necessarily Dimensional that's being selective. What I would say to counter that is that the philosophy that Dimensional brings to life, the point of view about investing, about capital markets, stocks and bonds, what we as investors can do, what forces we can harness to improve outcomes for all of us, that is a body of philosophy. Put another way, a set of ideas Dimensional absolutely subscribes to. And something that we're looking for like you might expect, is that we're looking for a similar set of ideas, a similar perspective, a similar philosophy from the advisors that we're going to work with. So I would say in a lot of ways, I think the thing that does the selection is that philosophy, that approach.

Because something that I know that you know this, there are many different ways to invest, a ton of different ways to skin the cat. The philosophy that I know your firm and my firm Dimensional has in common, the philosophy that we share is shared by many, many other financial advisors, but not everybody. Not everybody views the world or invests on behalf of clients the way that we do or your firm does. So, I would say that selectiveness is really a function of weather and the advisor, our client, Dimensional's client, buys into the philosophy. Again, agrees with the empirical evidence of where returns come from, which we may touch on. If they agree with philosophically, how do I put the interest of my client first? How can I maximize good quality outcomes for those clients? Again, getting a reasonable return for a reasonable appetite of risk. A belief that ideas like risk and return are probably related when you have competitive capital markets like we do.

So, I think what we're always looking for is that common belief system. I wouldn't say it's a set of requirements. We're not evaluating or approving advisors. What I will say is to rewind all the way back to the history of the firm founded primarily by David Booth, David's vision for the firm was to make available investment strategies to everyone. And even when we were working with institutional clients, there was an appetite for strategies a lot of other managers simply didn't offer. That's where we pioneered our first strategies, and a lot of our clients back then were pension funds. And naturally as everyone knows, pension funds are full of assets that are intended to match the liability down the road to pay out pension benefits to beneficiaries.

So even though we were working with institutional clients, what we were really doing was funding and caring for the assets that were going to be in the form of pension to a lot of people down the road. And as we've evolved, as the workplace has evolved as probably everyone recognizes, pensions are harder to find. It's quite unlikely that people get pensions in the ... I should say, it's quite unlikely that people get pensions in the private sector. More often people are managing their own money or have the option of managing their own money.

That's where our work with advisors really came from, is that suddenly the financial adviser business had really mushroomed starting in the 80s, going into the 90s into today and again, that's where we can benefit those end investors by partnering with advisors, so we want to be there. Philosophically I think David would say, "We want our strategies to be available to as many like-minded people as possible." I think the key there is the like-mindedness that we do share a view of where success comes from in investing, and not everybody shares that.

Tony D'Amico: Yeah, that's really interesting. So there's a little bit of a self selection process, right?

Christian Newton: I think so, yeah.

Tony D'Amico: Advisory firms might self select out because they're not like-minded or they don't share that same philosophy. That's really interesting to how you guys started primarily with pensions but then as the landscape changed, you made your funds available to those avenues. So, Christian, I guess, how would you describe, because I obviously understand the philosophy Dimensional really well and there are certain aspects of the market that you guys have an excellent long term track record. But, how would you describe your investment philosophy?

Christian Newton: Well, to me the heart of the philosophy is the idea that capital markets are very competitive, and our belief that markets work. That is, put another way, that the effort that capital markets do in pricing securities, every day the stock market opens and counterparties come together, buyers and sellers come together, all of them in a friendly disagreement about the right price, the price that will motivate them to sell a share of a company or buy a share of a company. And the changes in prices our view is in a very competitive market, are a great source of information about what we can expect going forward.

Put another way, the prices markets generate today give us really valuable information about the returns we should expect going forward. And when I say really valuable information which is a technical way of putting it, what I mean is we can measure the market today, measure the prices of all of those investment options, all of the different stocks that are available to us in the market, and we can articulate portfolios where we have a positive expectation that we will not only deliver let's say the return of the total stock market, we might often call that a benchmark return or the return of an index. But, we can expect to go beyond the return of the total stock market. That is, delivering a higher expected return than the stock market, all by measuring the market today, measuring prices today to give us information about the future.

Again, that idea is really essential to our worldview. Our worldview says, we as investment advisors managing a mutual fund do not need to articulate a prediction about the future. We don't need to articulate a forecast of what's going to happen tomorrow. We don't need to have a forecast about the price of a particular company. We don't need to have a forecast about macroeconomic conditions, good or bad news happening in the world. Rather what we can do is, we can allow the market to price those uncertainties, look to the price today to again, give us information about tomorrow.

That view of how markets work, the utility of that information, and the idea that you don't need to have an opinion about the price of a company, "Oh that price is too high, that price is too low." Or, maybe more broadly and a more accessible example, I don't need to have an opinion of how the market as a whole will do tomorrow, or the day after that, or the day after that, or even a week or a quarter or a year in the future. Rather, I can put the academic evidence about how markets work, where returns come from to work for me, and not have to have any forecast at all.

That doesn't mean I'm going to invest irrationally. It doesn't mean I'm going to ignore a lot of important investment choices but rather, those investment choices are going to be baked into an investment plan. And again, that investment plan is probably going to tap into ... If you're using Dimensional strategies, it absolutely is tapping into this idea that the market is better at pricing securities. I'll put that in another way, assessing all the uncertainty either macroeconomic or specific to a company about every single investment opportunity in the market, we would argue the market's better pricing that than any one expert. I think that's really what sets us apart. Not many other firms invest the way we do because again, there's no forecast. If you want a Dimensional strategy, you're not paying us for some idea of what's going to happen tomorrow. Rather, you're buying this strategy that looks to the market every day to determine in a sense, what we should own tomorrow.

Tony D'Amico: Christian, that's really great and helpful to our listeners, that academic or evidence-based approach where you ... There's research that has determined, what are the dimensions that you can look at, that our determinants of future returns or exceeding or future expected returns, and how to enhance them, right? So, it's that whole academic evidence based approach. Knowing what those dimensions are is really important, so there are ... That long term approach where we know over the long term that stocks do better than bonds. But, do you want to talk a little bit about the different dimensions that have been identified as that they've been persistent and they could be traded on? Because those are all ... And I don't want to segue, right? Those are all important factors to right?

Christian Newton: Yeah, for sure.

Tony D'Amico: Can it be executed on in a cost effective manner? Talk a little bit about maybe some of those dimensions that are looked at when purchasing either stocks or bonds.

Christian Newton: Yeah. This idea of a dimension, you can ... The way I think of it, it's just like in three dimensional space, or we might call the Euclidean space. A dimension means I can move left or right, or I can move up or down, I can move forward and back. Those are the three dimensions that we as human beings are accustomed to, and that's exactly what the research coming out of an academic view into finance that is answering the question, where do returns come from and why? I view that as a scientific enterprise. I would say finance and economics generally, it is a social science, but especially econometrics which is the tradition of again, measuring the market, measuring capital structure, measuring economic activity, in order to determine empirical insights, and that's a key difference.

Empirical insights, meaning something we measured out in the world, something we measured in the returns of one set of stocks versus the return of another. It's not simply a theoretical idea, it's been measured historically. That's literally what empirical means. So, putting this empirical research to work expresses itself in this idea of dimensions. So, what is a dimension? A dimension simply is a measurement I can use today, looking at stocks or bonds today, to have a sense for what it's likely to behave like in the future. Put another way, I can use a measurement today to form a basket of stocks where I have a strong expectation over time and over the long haul, they will have one particular type of return, and I now have another basket of stocks that have a different measurement that's going to have a significantly different return over time.

We call that systematic returns, meaning it is a return that comes not from owning a single company where of course if I have an investment portfolio that's formed of a single company, like you would guess, I am significantly invested in the human capital risk of that company. A single product, a single fabrication line fails, I'm probably going to suffer negative returns because of that one company. If rather I own 500 companies, or 1,000 companies, or 10,000 companies, we call that diversification. Rather than concentrating my ownership, I spread my ownership out. In fact you could argue, I want to spread my ownership out to every market in the world that is competitive, where every day there's an auction, a competition about what the right price is.

Now I own thousands of stocks. With those big numbers, with those thousands of stocks, I can use these measurements, these dimensions to say, This basket of stocks if I look at the empirical research, has a lower return over time. This other basket has a higher return over time." And those return differences can be big. And when I say big, I say maybe I might articulate just to make one up, maybe 1% a year on average over a 20, or 30, or 40 year investment lifespan. 1% a year, it doesn't sound like a lot. 1% difference in height or weight doesn't sound like a lot, but 1% difference compounded every year over 20, or 30, or 40 years, those are really big differences in terms of wealth.

Tony D'Amico: It's a staggering amount of money.

Christian Newton: Exactly. The academic research for these dimensions were identified, and I want to impress upon you that these are not proprietary to Dimensional. It's not a black box, it's not a trade secret of Dimensional's. These ideas were identified and published in academic journals, many of them in the 1970s, 1980s, 1990s. That work in fact, continues today, identifying these differences in returns. So often when we're talking about application, when we're talking about the strategies that Dimensional manages to tap into these, we'll talk about the dimensions and the primary dimensions that we form portfolios around.

Again, where we're going to adjust those weights to different buckets based on different measurements in the market today are going to be what we call size, that is how big is the company? And I don't mean by employees or sales, although those are metrics you can use. Traditionally, the metric we use is market capitalization which is simply, what is the total worth of this company based on market opinion today? I want to take the stock price today, times all the shares outstanding in the universe. That tells me the market capitalization of the company, and that is one of the dimensions.

Now that all sounds pretty straightforward, but this is what is often counterintuitive for folks, is that if I compare returns of small companies, companies that have low capitalization versus returns on big companies, companies that have really big capitalization ... To make a caricature out of it, big cap companies are usually companies we've heard of. I won't use any names I think for today's purposes, but big companies you've heard of. They've been around forever really successfully, you see their logos and products everywhere. Those companies often have large capitalizations.

If I look at those two baskets, large and small, and I hold them over 20, or 30, or 40 years, even just a couple of years, over time, the basket of small cap companies delivers a better return. Now, that is a counterintuitive idea I think for a lot of people and to some degree, that's a big part of my job because these academic ideas do run counter to people's intuition. We want to make sure people are educated about what to expect if they're going to invest in these kinds of strategies. This is a long answer to a very simple question. That's just one dimension, how big is the company?

And very briefly, I'll mention another dimension before I throw it back to you. What is the ratio of the price of the company today, versus what it might be worth if you just liquidated it? If you just sold it at auction? What's the book value of a company? Now that ratio, the price that the market puts on the company versus again, the book value of a company can be really useful for giving us a sense to put it into plain English, of how expensive the company is. You can have two companies, they're both retailers, they both own the same amount of land, they both had the same number of cash registers. If you liquidated them tomorrow, they'd more or less have the same value, but one based on its market price is much, much bigger.

Usually that's because again, it's a company that's doing better, has better sales, maybe has a better product, maybe just has a better business model. For whatever reason it is. And that's a key idea is, we don't always know why the market prices a security the way it does, but we do know the price every day. For whatever reason, that stock is more expensive to buy per unit of its book value versus another stock that's actually really cheap. It's actually been deeply discounted per unit of book value. That ratio, we call it a ratio. Again, it's really just another measurement coming out of daily prices in the market, gives us further still information about which basket of stocks we expect to deliver a higher expected return going forward, and which we expect to have a lower expected return going forward.

So, the dimensions give us as investors a lot of ability to control a really important idea which is, how much risk do I want to take on? How different do I want my investment maybe to look than say the market as a whole? And, what kind of a return should I expect as I do my planning, my wealth planning, as I figure out my goals and ... I feel like every investor and most investors have, but I think it's worth reflecting on, ask themselves, "Why am I investing at all? Is there a well articulated goal that's driving these decisions.?" And again, usually when an advisor is working with a client, that goal has been defined.

I feel like that goal usually determines the degree to which an investor might use some of these dimensions. And again just like a dimension of movement, you're free to choose any particular position. There is no wrong portfolio, it's simply ... The way I view it, it gives power to the advisor, and it gives power to the end client to determine, "This is a portfolio that fits me, fits my needs and fits my goals." Dimensions just help us to fine tune those expectations.

Tony D'Amico: Sure, and Christian you took the words out of my mouth. I know that you guys use size as a dimension, the size of the company, the price in consideration of the book value, right? The profitability of the company, and you have-

Christian Newton: That's a third, right.

Tony D'Amico: Yeah. You have all these dimensions that you apply to stock selection to improve expected rates of return, so very important. And with bonds you're looking at what? Term and credit, right?

Christian Newton: That's right.

Tony D'Amico: Just like bonds, and there's certain evidence there in the data, in the long term data. So, very valuable stuff. But the most important thing that you just said is that you're not investing for the sake of investing, you're investing because you have goals. They could be short term goals, they could be longer term goals. That is just so important. Our philosophy is to start with a financial plan. Number one is to create a comprehensive financial life plan for someone, before we recommend their asset allocation and how to invest because you're right, those dimensions are very important, a very key piece. But, it's all about helping them have a financial plan that has the highest probability of success. So, how do those investments support the financial plan? Very important.

I mean, historically ... Our industry has evolved quite a bit the last 30 years but in the old days, it was just people would fill out a risk profile questionnaire and that's how they develop their asset allocation. And we still do that, it's a tool, but the financial plan is that their investments need to be benchmarked to that just as much if not more than a risk profile questionnaire. I'm glad that you shared all that because that's really helpful. And it's all about trying to improve probabilities, right? There's no guarantees, but it's all about probabilities.

And if I could, I want to switch this a little bit and talk about ... I mean, there's other things that you guys do that we can talk about, but let's jump for a minute. Let's talk about practical stuff because we're filming this May 27th, 2020, right? We've obviously-

Christian Newton: You don't have to remind me. It's been a unique year.

Tony D'Amico: Very unique, right? We have COVID-19, but yet you ... In my opinion, there are undeniable investment principles that you have to keep in mind. Now, are there other ways to invest that can be successful? There are. Do I believe the way that we invest has the greatest degree of probability? I do. As a fiduciary, obviously I would adjust it if I felt otherwise, right? But, I guess just about current events. I mean, in March the markets fell so quickly, very quickly, at one of the quickest rates in history. Part of this philosophy from our standpoint is trust in the capital markets.

The markets in the short term are very irrational. What does that mean? To us, it means that the movements aren't predicated on anything that means anything, it's completely irrational, right? So, markets are irrational in the short term. Over the long term, we have expectations that the value of a share will reflect the value of the investment. But one of those ... That comes to mind as to me an undeniable investment principle, that in the short term markets can be irrational. As one of your academic consultants call it, it's a random walk in the short term.

Christian Newton: Right, right.

Tony D'Amico: I think what I'm getting at too, which I think this is really important. The markets were terrible in March, right? And what do you do? I mean, we viewed it as an opportunity to rebalance our client accounts. Now, we're not talking about doing something tactical and changing strategy, but if a client was 60% stocks and 40% bonds and they're 60% stocks became 50 because stocks dropped, bonds and have done well the past 12 months, we sold the winners to buy the losers, which was most case was selling off bond funds to buy stock funds while the prices were lower. We don't know if it's a rock bottom sale, but we know it's on sale relative to the price that was in February.

We rebalanced a total of six times, which I think is imperative. You guys manage a lot of money, right? Up to the crisis, we managed about a quarter billion of assets before COVID-19 set out, but you have to have it scripted out. You have to know in your head, what's the investment philosophy? How does it support our clients financial life plans? What will I do if something like this happens? Then you have to do it. And I'm talking freely here, but then April happened. April was one of the best months in the market in the past 30 years.

You knock the whole thing, "Oh, long term discipline, stay disciplined." Well you know what? That is really important and it surfaced here again. And I'm thankful out of the 200-plus households that we serve, we didn't have anyone that broke discipline. Did we have to have some calls? Yeah, and that's what we're here to do. We're happy to do it. But, we know and you guys have this data as well, we know that if you react to the markets dropping and if you just miss a few of those days, because we know the best days happen right after the worst days, and I don't mean to rant here too long.

Christian Newton: They often come together, yeah.

Tony D'Amico: Not always, but the best days happen after the worst days and if you miss those best days, then it hurts your return. And if it hurts your return, what is that doing? It's basically going to mean that you have to reduce your lifestyle in the future, or change your goals. I want to get your take on this. Going through this and executing this for our clients and helping them stay the course, I just think that there's a handful of undeniable investment principles that rose to the surface again. What's your thoughts on that Christian?

Christian Newton: I think you're spot on. I would say that March and April were ... It's nice to use the past tense, were I think a crucible for a lot of investors. A test of investor discipline. Because exactly like you articulated, suddenly markets changed and they changed a lot. For some people understandably, that creates anxiety or fear. And why does it create anxiety or fear? Well, because they have wealth in the market and now their wealth has been discounted. Why does that upset them? Well, because that wealth means something to them. That's going to allow them to pursue charitable giving, put a grandchild through medical school. Whatever it may be, that wealth has meaning so naturally, we associate an emotional response to that change in the one day valuation of every share, of every stock in the world.

This is something that I always talk about with retail investors, is this idea that every day we are peppered with the price of all these investments today. Every day if you turn on the NBC News, Lester Holt will tell you how the S&P 500 did, which by the way is not the total stock market, it's just 500 famous companies. But, you could do worse as a proxy for how the market did and he'll tell you how that S&P 500 did. Every day you get a new reminder. When the stocks are up, well guess what? Part of you has a little bit of a greed trigger perhaps because now you are more wealthy by 1.5%. You did nothing. You just went to work, did your commute, took care of your kids, you're 1.5% wealthy? Well, that feels good. But then of course on a down day, especially days that are violently down, we're now suddenly 7%, 8%, 9%, 10%, 12% less wealthy on paper, it is not a realized loss. Naturally, we're going to react emotionally.

The one thing I'll challenge in your narrative, which I otherwise agreed with, was the notion that markets in the short term are irrational. The only way I would soften that is I would say they have the potential to be irrational. But I think one of the challenges for us as investors is the way that markets are pricing securities today, often is in conflict with the headlines that we see today or the day before. So yes, in February and March as we were seeing that the Coronavirus was A, going to be really dangerous for the United States, B, probably require I'll call it a domestic wartime footing. By that, I mean a significant scrambling of the relationship between government, free enterprise, labor, capital, et cetera. All bets are off, people aren't going to work, we all know what that felt like. And because of that, suddenly the market drops and it drops quickly.

I don't agree with the idea that those fast changes are always irrational. After all, you have all these counterparties in the market. They all have different ideas, different estimates, different guesses maybe where the market is going. But the market as a whole I think we can agree, is forward-looking. People in the market are trying to figure out, what is the return on a company that's in the cruise business? What's the return on a company that's in the mass retail business? What's the return on a company in the airline business going to be? Because when we have this new news that we know is going to affect these industries in different ways, suddenly maybe there's a new level of profitability, a new set of revenue, a new set of sales for all those companies.

Change means new prices, and those prices are forward looking. So the same way that those discounts happened and happened quickly and were disappointing, on some level it made sense to me because the headlines were quite scary at that time. But then a month later, I think we had the opposite situation where markets again, are they looking to next quarter? Probably. Are they looking two or three quarters out? Well, some market participants are. After all, that is one of the great things about markets, is nobody controls them. Everyone is free to transact or not. All that volume that happens in the market every day is free enterprise, free activity by independent parties. No one controls those prices. And because of that, we can harness that information.

And again, sometimes you have the market going up even when the headlines are bad. That again is the catch for me, is we get these prices every day. What we don't get is a perfect explanation of why the price changed because again, nobody controls it. Nobody can truly tell us. And the media does this all the time. They'll say, "Prices dropped because of this news," or this action by the Fed. There is probably correlation, but you can never claim to know what every market participant was doing on any market day.

I'll close this thought with ... I'll limit myself to one Godfather quote in our conversation today, but I think this one is apropos. If you know the Godfather as well as I do, it's one of my favorite movies. Early in the movie when Tom Hayden, the Don's attorney goes to Hollywood and he asks a famous producer to cast a friend of the Don in an upcoming movie. The producer in a very colorful way, which I won't repeat here declines. He says no, so the attorney gets up. They're having dinner and he says, "Well, thank you for the pleasant meal. If you could have someone drive me to the airport, I'm going to fly back to New York tonight." The producer says, "Well, what's the rush?" And Tom says, "Well, the Don likes to get bad news right away."

I feel like the stock market is the same way, it responds to bad news right away. Yes, the market dropped quickly in one day. If you look at that day's chart, most of that price change happened within just a couple of minutes of open and with a couple of minutes of close, the market moves that fast. And again to me, those are the stakes for us as investors. Like we said at the beginning of our conversation, not everyone invests this way. Not everyone trusts prices, not everyone trusts markets. Some people want to go out into markets and speculate, and concentrate, and time the markets and we could all understand why. Because if you can do it successfully over, and over, and over again, if you can be smarter than every other counterparty in the market, and to me those are really the stakes, over, and over, and over again, well you can make a lot of capital really, really quickly.

But there exists this powerful alternative that again, comes out of academic research that says we can actually have very reliable outcomes. Like you said, they're not guarantees. That's an insurance product, not an investment product. Investment by definition means I am paying for to take on a risk from someone else. The risk means I may be compensated positively, it also means I may suffer a loss. That can never be removed from the act of investing. But, this alternative to diversify, to not respond like you talked about, and that notion of rebalancing. To me, I think so many investors forget about the power of rebalancing. That's why I call it ...

Your investment plan is on autopilot and rebalancing again like you said, it's a purely mechanical activity. Automatically what is it doing? Well, it's selling one set of assets and buying another. It's selling high and buying low. It is literally doing what you do to invest successfully. And because it is detached from our emotional response, or again, from what we might respond to in a headline or a chyron on cable TV, we're putting the odds of success in our favor if we can be disciplined over the long haul.

That's why, not to make a caricature out of it but to me, if someone has good wealth goals like you mentioned, if they have an investment plan that is a function of those goals and they have the time ... A good plan always includes the amount of time I have, until I need to turn that investment into some kind of consumption. Whether I buy a yacht or sponsor a charity, a university or whatever I'm going to do with that money, eventually every investment becomes consumption, at least in my belief. That time horizon allows us to not have to respond. To not have to respond in an emergency.

I limited myself to one Godfather quote, I'll limit myself to one Warren Buffett quote as well. Warren has famously said among other things, "Capital markets exist to reward the patient at the expense of the impatient." I want to be careful with that quote because Warren is not saying impatient people are stupid, he's simply saying they need to get out now and if you want to get out now, you pay a premium for that. You have to pay someone else their price, not yours, in order to transact today. That idea to me extended day after day, quarter after quarter, year after year.

For those of us, people like me, who very successful career, very proud of, but I still need to put my capital to work to have the kind of retirement I would like. I need to have that discipline every day not to respond, not to react, and a good investment plan allows us to navigate through March, and April, and May. In my estimation, it will allow us to get through the rest of this year. You heard no prediction from me over what the year is going to look like, but it will allow us to invest with confidence.

Tony D'Amico: Yeah, it's a long term plan and I love some of the distinctions that you just mentioned. Going back to the short term, what I hear you saying is that the markets can be irrational in the short term. They have the potential to be, but they're not always but sometimes they can be. Is that what you're saying?

Christian Newton: Well at the end of the day, what's a capital market made of? It's the punch line to the movie Soylent Green, if anyone out there is a fan of Heston and science fiction. It's made of people. Markets are made of people trading, and transacting, and acting. People, or people on behalf of other institutions or other wealth funds, whatever it is. It's always people. So yes, the sum total of people can be irrational. The question really is, do I as a single individual investor, do I have an opinion over what the right answer is that's going to be two things, better than the markets price and eventually, the market has to agree with me? If the market never agrees with my idea, I'm out of the money forever.

So, I will definitely agree that individuals can be irrational, even big collections of people can be irrational. I think our notion is that if you give investing ... And you could also ... You could broaden it and say if you're giving capitalism. I would say if you're an investor but you don't really buy into capitalism, that may be a tough fit for you. But if you believe in the idea that you can put your capital to work with an expectation, not a guarantee, but an expectation of reward on that capital, that you can invest over the long haul and you can ignore those short term like you called it, which I think is a great label for it, noise.

And that's a big part of what the academics have done, it's a big part of what Dimensional does in the investment vehicles themselves, is basically help to separate the noise from the signal. The signal is the stuff like, how big is this company? Is it big or small? That gives me information about the future. Is it a value company or a growth companies? Does it have high profitability or low? Those are all signal data that we use every day. The noise is everything else. The movement of an individual company-

Tony D'Amico: So, perhaps there's-

Christian Newton: ... Analysts' opinions of companies, and so forth.

Tony D'Amico: Or, maybe there's a lot of selling one day out of fear about the coronavirus. Like what you said, we can speculate that's why maybe there was a sell off that day, but we don't know for sure, right?

Christian Newton: Yeah, and that's the thing, right. I mean, I feel like people often talk about the market like it's a god. The gods are angry today and Poseidon threw ... What is it? A trident? I guess that's Poseidon's weapon. The gods are angry and here is why. I feel like again, I think it's a natural thing to do. I'll go back to this ... One of the big analogies that I share with investors is that I view capital markets like a force of nature. They are not a force of nature, they are an invention of humankind. I think maybe one of the most interesting inventions we've ever created. But again, like a force of nature, who controls the weather? Nobody. Who controls geothermal activity? Nobody controls it. Despite that, we can harness those powers. Can those powers in the wrong place at the wrong time like getting struck by lightning injure us? They can, but we can again, protect ourselves against those unusual events and harness over time, these really powerful forces.

One of the analogies I've used with people is, the way I view a diversified investment strategy that owns every public company on Earth, more or less every company we can find where every day we can get a good price of what the market thinks it's worth, to me that's like setting up a windmill in front of all of these operating companies on planet Earth. Now, for which company tomorrow will the wind be blowing really well? I have no idea. I don't have a prediction there. I am not in that business. We believe that's simply too difficult to do because of course, what is the market doing every day? It's pricing in those expectations every day. In a sense, those predictions are worthless because you have a new set of prices. Harness a natural force without having to take those risks I think it's really positive.

But I think again because nobody controls these forces, people often treat them like again, the behavior of the

Greek or Roman gods or something. We make up a story about why they're doing what they're doing, but nobody on TV, not even any academic I think worth their salt is going to claim they have that magical logic of why the price was the price that it was because it is simply too big and too chaotic and because again, nobody controls it. Nobody is ever forced to trade. And like you said there, on a day there are more sellers than buyers is what they say, which is another way of saying prices dropped. But every day by definition, every seller has a buyer, right? That represents a new price at which one person said, "I got to get out, I no longer want to own this particular stock." And someone else said, "Well, I'll buy it. You got to wait a little bit but if you get to this price, I'm happy to buy it at that price." That's what happens every day.

So yes, there can be more selling pressure but every day if there was a transaction, a buyer and seller came together freely, and I think it's ... You can argue that materially, they both benefited from the transaction. Again, that's our view of markets, is that they are so big and so competitive. We don't have to compete in them, rather we can harness them and put all of that power to work for us in a lot of ways. The key is like we're talking about, it's often not intuitive, and you almost always want to have an objective, informed participant to help you articulate what your plan should be. Because doing it yourself is difficult because I want to argue, we can never be objective about our own wealth because that wealth plugs so much in to what we want to accomplish while we're on Earth.

Tony D'Amico: Yeah, no doubt. I think the other thing too, that you've talked about there or hinted at is that today and for a long time, information moves very quickly. So, there's the belief that the price today reflects the sum of all known information. And information moves so quickly, so rather than trying to outguess the market, harness the market, know what the long term empirical data is and then construct the right asset allocation, which should be done very carefully to support the goals. Then stick to it, which people might be sick of hearing, but it's really, really important when we look at how the markets, especially the S&P in April had one of its best months in the past 30 years. Really, again just that concept arose. Again, the markets move fast.

I mean, we get there's information out there that there could be a possible vaccine. We don't know for sure, but that may have been the reason why the markets jumped up 3% or 4% the day that that news came out. We don't know for sure, but markets move fast. So if you're not in the markets, you can't participate in that growth. So again, I think that that concept definitely surfaced again, that the best days not always, but often follow some of the worst days and if you miss out on those days because returns can be concentrated, then you miss out.

We've also been talking a little bit about diversification. I think that's another really important concept. It's this whole concept that there's a statistical measure, correlation. You know this as well as I do, that we know that certain asset classes are not going to follow one another exactly. They're going to diverge, and we want that, right? I think that's a really important concept. It's something that we often will re-review with a client to show them. We love using funds that have a high degree of asset class parity, so if we have ... At any point in time we could have 12 to 15 different funds and they're all different asset classes, and they're going to be doing different things which I think is really important.

A diversified portfolio right will always be frustrating because intentionally while some asset classes are doing well, others are not going to be doing well. I guess an example I can throw out there and I'd love to get your feedback on this, is that I remember in April being involved in a client meeting and just looking at their asset classes over the past 12 months. Well, about 40% of their portfolio was up over the past 12 months, 60% was down. But the point to them was ... They're not retired yet. We have clients that are retired, some that are heading up to retirement.

But my point to them was, well if you were retired today, these assets that are up over the past 12 months in spite of the COVID volatility, my question to them is, would you spend ... I said, "Would you spend 30% of your portfolio this coming year?" The answer was obviously, no. So, I think that's another ... I guess an important point here is, having diversified portfolios does create the opportunities for rebalancing, but also liquidity needs. We could sell what's up in the account, so we ... I like to stress that because I think there's too much focus on what the whole account is doing.

Christian Newton: Rather than the moving parts.

Tony D'Amico: Yeah, but you don't really experience a return until you sell it. It's nice to track returns ongoing, but what's more important to me is the actual internal rate of return, not the time-weighted return. But let me throw that your way. What's your thoughts there, Christian?

Christian Newton: Well, yeah. I mean diversification, if we're talking about the body of again, the academic work, the notion of diversification, that's at the heart of modern portfolio theory. That is a Nobel Prize winning idea. That has I think driven and hugely improved outcomes for millions of investors. But it requires diversification just like you said. It requires the willingness to own assets that are going to move in different ways, that are going to go up and down. That means accepting ahead of time the idea that at times, some of my assets will go down maybe dramatically in their valuation in the market. But just like you pointed out I think very astutely, I have not realized that loss. That's just what the market thinks today. I haven't touched my shares, but the market thinks X today. It means of course, having assets that also will go up in that time period, we might expect them to go up.

But to me, diversification is really tough because again, it's another counterintuitive idea. Why is it counterintuitive? Because I want to argue that most of our lives as human beings, maybe put more specifically relative to wealth, most of the story of how your clients and how most investors came into their wealth to begin with was not through diversification. Take me for example, I pursue a couple of interests in high school, turns out I'm not great at one but I'm better at another. I have one major, I have one degree, I get one job, I moved to one City, Los Angeles, I work for one company, Dimensional. At every step, I'm concentrating. I learn more and more about Dimensional, I get more and more specialized. What am I doing? Am I diversifying? Do I have a night job? No, I'm concentrating more and more of my human capital on a smaller and smaller swatch of the universe. Why? Because I get compensated for adding value in that smaller swatch.

But investing is the opposite, if you're pursuing it the way we're talking about. By concentrating, you do not access that systematic return. If I have a portfolio of 10 companies because I like their name or their products, or their CEO is a really charismatic and colorful person, I can't form a portfolio that has dimensionality. The dimensions just don't work. You need to have what we call systemized exposure. You need diversification. You want to have a portfolio of hundreds or thousands of companies, then you can see that dramatic difference in returns both expected and realized.

But again, diversification runs counter to our experience. Most of us have one or two kids, we get married once, maybe twice, we have maybe two houses. Most of human life is a story of concentration, and especially for people who are lucky enough to have had a great idea, founded a company, sold it for a huge liquidity event. I can't walk up to that person and say, "Oh yeah, your concentration was foolish. You should be diversifying." When it comes to human capital, diversification, rather concentration is terrific. But when it comes to investing, very counterintuitive. There is this option, there's this alternative where we can diversify, hold big baskets of stock like you said. The movement between those is running ...

I often think of that as the transmission of the investment plan. All those different gears moving at different speeds to accomplish different things, but it means owning everything. To put it maybe into really almost comically stark terms, it means accepting that we're never going to have the winning portfolio. There's always going to be a sector, or a country, or even a dimension that's doing really well over a particular period of time. Last year this country had the best return, last year this sector had the best return. If I diversify across countries and sectors and dimensions as most investors who pursue this approach do, I'm never going to have that number one return. I'm also never going to have the lowest return. Because this is a mathematical identity, I'm always going to be stuck in the middle as a blend of all of those returns.

So again, in a lot of ways it doesn't emotionally feel good. But the reality is if we want to put the odds in our favor of long term success, to rewind it back to the core goals. If I have goals that are reasonable for me to accomplish and an advisor can create a plan to accomplish them, that plan is the autopilot. I can do nothing. I literally can do nothing for 40 years. I can pursue whatever else is I'm passionate about, and it's like ... My mentor at Dimensional said thinking about, should I transact? Should I trade? Should I get out of one asset class into another? Should I go to cash? They said, "Your wealth is like a bar soap. The more you handle it, the less you have." So, that idea of creating a plan and leaving it alone, letting it run on autopilot again, informed by 70 years of academic research into, where do returns come from? What kind of returns should we expect? What are the risks and how are they priced? How can clients mitigate those risks? Putting all that research to work for you.

But again, to me it's like the transmission of a car. It represents hundreds of thousands of hours of engineering expertise, but I just sit in the seat and I hit one pedal and I go. I think that's just hard for some people to internalize and accept, especially I think because for most successful people who have been rewarded with some kind of a wealth, capital wealth and other kinds of wealth, that's happened through concentration. So, it does take I think a little bit of education, and it just takes some room to decide if it's for you. That's something that I will tell people who ask me questions after a presentation and they say, "I'm just not sure this approach is for me." That may not be for you. Other ways of investing may be a better fit for you. It's not my place to say that someone is wrong that way, but at least education allows someone to know what's going to be a good fit for them.

Tony D'Amico: Yeah. Christian, I'm jotting down some notes of things I want to follow up with you on because that was ... You said a lot of really awesome things there. I love the twists that you bring to this conversation. But there's no doubt about it. You brought up a really good distinction for our listeners. Human Capital is not something that you typically benefit from diversifying. That's a very, very good point. And this could be a challenging concept for somebody that sells a business, and sells it for whatever it might be. 5 million, 50 million, whatever they sell their business for, that was concentrated risk. Now for a good bit of that capital, we typically see that they want to diversify. Maybe they just are happy with a goal of a 7% return net of fees in a moderately diversified portfolio, 7%. Rule of 72, if it earns 7%, it'll double every 10 years. That may or may not happen over a 10 year period, but we know long term capital markets have rewarded patient investors. That is a shift and it's a difficult shift, but it does happen.

Just quite interestingly, about two years ago ... This is a generic example. I'll change the industry. But, let's say that this person owned 10 hotels, but they actually wanted to sell two of them to diversify. They didn't want to have all of their eggs in the hotel industry, so they want to diversify. I guess the point I'm trying to make is that you're right, human capital ... And that's a very awesome distinction to. That typically in life with your decisions, a spouse, the children, the career, where you live, you take a concentrated approach and you're right, it isn't for everyone. I would say it's a core strategy. On occasion, we'll have an ultra high net worth perhaps investor that might want to take a concentrated risk, but they also understand there's a high degree of risk there.

Christian Newton: Yeah, I mean-

Tony D'Amico: A high degree.

Christian Newton: Yeah, maybe put bluntly, they can afford for that to go to zero.

Tony D'Amico: Exactly.

Christian Newton: For a lot of other investors, we're not going to commit every dollar that's going to feed and shelter us, hopefully in our old age for all of us. We probably don't want to take on that kind of outsize risk, because you can only ... As a friend of mine says, you can only wear one pair of pants at a time. In a dare, perhaps you can put on a few more. So, relating the consumption with the risks that we take to the polls to me is just so central to the conversation that I know advisors have with clients. And to me, there's a lot of rewarding dialogue that I know advisors surface with clients to help them think through again, how can I refine or improve the goals? Not just optimizing the investment, although that's always a goal, but also optimizing the goals.

I think when the goals are really crystal clear, at least as I have talked with a lot of advisors, and I would say this for myself as well. I think it's easier to live with the investments because I don't get distracted by that short term stuff and I can stay focused on ... Again, it's putting the odds in my favor, and especially being a lazy person. When I don't have to do anything, when I don't ... I said I wouldn't quote Warren Buffett twice, but I'm going to. I can skip the business section and go straight to the sports section, which of course right now is a terrible analogy. But you know what I'm getting at.

Tony D'Amico: I totally do.

Christian Newton: It frees you up to not have to be preoccupied with some of this stuff because it's painful. It's painful to experience all these unrealized losses. It doesn't feel good.

Tony D'Amico: Yeah. Having your investments again, grounded in a financial plan, a wealth plan, that's the key. I mean, I couldn't agree more. I love your distinctions that you're providing. I think that they're really valuable for our listeners. You know, another topic that really is something that I want to chat with you about, and I think it's really relevant right now. I've seen you ... You guys have a presentation where you look at these different news articles and what stocks they're going to predict that are going to be the best and have looked at that. But what really to be honest with you bothers me lately, is just the news and how difficult as an investor when you turn on the news and what I'm seeing lately is that the news in my opinion, they ... Bad news sells more, right?

Christian Newton: Yeah.

Tony D'Amico: When you turn on the news, even last night we were just ... I won't say the name of the show, but there's this comedy show that we watch together as a family and it's really funny. We were just in between episodes and the news was on in the background. They had this background music and his voice was talking like ... I'm like, "There's no way that that's his natural voice." I mean, it was like ... You thought the world was ending. I just have a huge issue with the news, the challenge that it presents for investors. I really think that the news, they don't report good news in my opinion and it could be challenging. So I guess, what are some of your thoughts there?

Christian Newton: Well, I'm not going to argue those points. I completely agree with you. I also know that ... I think the news has been very, I won't say scientifically, but very carefully refined. Let's see, since the birth of television news, I feel like we're still consuming most of us, some distilled version of that over the past, what, 75, 80 years? I think the news is really well designed to catch our attention, retain that attention and then catch it again, catch it again, catch it every five to seven minutes, because that's when the ads Come on. I agree with you that I think less news would be helpful.

The way that I often frame it for folks is I ask them to think of the news you expose yourself to like a diet, and I include certainly the paper, any magazines, Instagram, Twitter, any place where you're going to get information about the world. I don't care if it's just your friends on Facebook, I know that you're going to get exposed to news there as well. All I ask people to do is just be conscious of that diet for a couple of days and ask yourself ... Again, to me it's just like the diet we have of foods, and nutrition, and calories. Is there anything that I can cut out to where I might actually feel better if I did it, because I do feel like ... Again, I'm not arguing that people should be uninformed citizens. I'm not going to tell people which news sources right or wrong, I'm not going to go there. But what I do ask them to do is at least be conscious of all these sources. And just like you're suggesting, I think very often they're unconscious. We just have all these unconscious habits.

I'm so fascinated. If you look at the history of the media, every 15 years or so a new medium gets added. We have cellphones, internet on a big PC 15 years before that, you've got cable television, you can go back to radio. But despite all these added media, they still all exist. You still have AM radio, you still have FM. Now there are fewer people listening, but they are still doing what they can to get a little piece of the brain share of the audience. That's what you and I are doing right now. You and I are participating in an effort to connect with and hopefully inform and edify to a limited degree. I could do that for anyone, some perspective on what we're talking about. That's why podcasts are so popular, because they can make ideas available when someone like me is walking the dog and doing dishes or working out, at least doing the first two. It's been a while since I've really worked out, but luckily you only see me from the neck down.

So, that's what I ask people to do is if you take a couple days and be conscious of where you're taking in news ... I've done it, and I just canceled some magazines. I won't mention the brand names either, but these are actually very conservative, staged, not ... To me, really appropriate new sources but I still said to myself, "I just don't need this. I just want to simplify things and just take in a little less." And I do think it's just useful whatever people take away to think ... Especially if you feel like you are a frustrated or anxious investor. I think if anyone listening does feel like they're not okay with where their investments are at right now, I would look to your news diet and again ask yourself ...

The stock market does not take its marching orders from the media, or vice versa as we know. And to me if I have to pick one, I'll put my vote in with the stock market. Again, being this vessel doesn't get everything right every day but on the whole, on average, doing we believe a really good job of filtering through all the noise, giving me a good signal that I can bake into a mutual fund that benefits me of what the future is going to hold, again that expected return. I think it does help to again, think about how you can filter the media you're exposed to because I feel like almost all of us, it's more than we thought it was.

Tony D'Amico: Mm-hmm (affirmative). Yeah, that's some great stuff. Even for me, we've paid attention to it as a family. You try to turn to the news to keep yourself informed of what's happening with COVID, but then it turned into, oh man, they're just trying to grab attention through ... Fear sells, right? Greed sells. They know that and it is engineered to get our attention. So yeah, I revisited that myself. I won't name the name of the publication, but it's a very common newspaper that's sold out there. They're rated to be in the center, not leaning one way or another, and I just read it on my iPad every morning. So, I'm really trying to engineer myself where I get the news from because there's nothing worse than sitting down with your family and you're trying to maybe get caught up, but then it turns into something different.

Christian Newton: I totally agree. I was simply going to say I think to me, what you spotlighted there to me it's a difference between information and wisdom. Sometimes there's just way too much information available to us. If we pursue it, there's no end to it and we don't need a ton of information in order to have a wise perspective, a wise point of view. And I will say, not to talk too much about what you do but again, the way that I know advisors, the way I've worked with advisors, part of what the advisor is there for is if something does require attention, if there is some kind of an emergency with my wealth or my plan, the advisor's going to be the person who objectively determines, "This is something we need to look at. This is something we need to respond to."

It could be regulatory, it could be estate planning, or it could be something in markets. It's not impossible. But, so much to me of what the value of an advisor is, is again being an objective source not of just information every day, but of true wisdom. That's always worth paying for.

Tony D'Amico: Yeah, no doubt. One of my favorite Warren Buffett quotes is be fearful when others are greedy, and be greedy when others are fearful.

Christian Newton: Easy to say, hard to do.

Tony D'Amico: I can just replay half of March and April, and just seeing the markets. It was time to act on those in my opinion, undeniable investment principles that others have figured out before us because that's the quickest ... The best way to shorten the recovery time is to buy more shares when they're cheaper, right? That's obviously our goal. It's a long term plan as we've talked about. It's not a plan for two years, it's a plan for 20 years plus. Christian, is there anything that we didn't talk about today that you wanted to chat about? I know we went a little bit longer.

Christian Newton: How much time you have now? No, I'm just kidding. I'm really glad our conversation focused on this set of ideas, the philosophy. Dimensional obviously as an asset manager, there are ton of talented people in the firm. We take that philosophy and we bring it to life. Every day, the portfolio managers and traders, the people in our research group, people like me who work with advisors go out in the field and tell our story. But at the end of the day, it is the set of ideas that's most important. We're just really proud of the idea that again, nobody owns those, anyone can put them into motion. But if you are excited and energized by these ideas, Dimensional and the advisors we work with, I'm going to bundle us all together and say I think collectively, no one has been delivering on this philosophy as long as all of us have, and I think that experience can really benefit investors out there.

Tony D'Amico: I couldn't agree more. It's one thing to have the ideas, it's another thing to be able to implement them. I think that's the difference that we see and are awfully impressed with Dimensional, is the implementation, the track results and I think the same thing goes for advisory firms. I think there's a lot of advisors out there that do financial planning and wealth management, but there's a difference between level and depth of it, and really having a true integrated wealth management plan. So, I think it all really comes down to implementation. Christian, I really appreciate your time today. I've enjoyed it, so I'm hoping that we do round two of this in the future.

Christian Newton: Yeah, let's do it again.

Tony D'Amico: But in closing, my last question for you. This podcast is really about helping people get knowledge to help them achieve success where wealth and life intersect. Success means different things to different people, and what it means to be wealthy also means different things to different people. You've really accomplished a great, phenomenal career at Dimensional. And I guess when you think about the intersection of wealth and life for you moving forward, what does success look like for Christian?

Christian Newton: You know, I think ... I mean, this is ... My answer definitely applies to my work at Dimensional for sure. My work there is not done, but I would say that to some degree I feel like in some miniature way, it's true. But, I think it also applies to everything else in my life. I think to me, the notion for a lot of the thinking I do about my wealth and how it drives the decisions I make and how I use my time, it's ... I'm going to quote Steve Jobs. I don't know if there's a quote behind Jobs' use of this quote. If there is, I'm not familiar with it. But, it's the opportunity to make a dent in the universe. He's said that.

I think about what drove him as a very young man and an entrepreneur, and obviously contributing significantly to the birth of the microcomputer and home computing and a lot of other stuff. And so, everyone I think defines that differently. I'm not saying I want to make computers, that ship surely has sailed for me. But that notion of whatever your universe is, being able to make a dent in it. That may be in raising a family, that may be in again, creating an object or a computer. That may be just in telling a story, and that is really what I do most of my time at the firm is I'm either telling a story to someone, or I'm thinking about how to tell the story better. That project I feel like, collectively for the firm certainly is never done. We're never done figuring out what's the best way that we can make an impact.

So in a way, the dent in the universe for me through Dimensional is again, just helping people to better achieve their goals in really tiny little ways. I can't help as a portfolio manager or a trader. No one would ever want me to do that. But I think I can contribute again, in thinking about how we think, the philosophy of the ideas. Making a dent in that. And again, there are a lot of other very talented people at the firm who have made dents way bigger than mine but the opportunity to make a dent in the universe, to me, that's just what gets me out of bed in the morning and it definitely drives how I think about, what can I do with the wealth that I have and how can I put it to work?

Tony D'Amico: That's awesome Christian. Again, thank you so much and your framing, your analogies, your movie quotes, that was awesome. I'm 100% confident this will help our listeners so again, thank you very much and look forward to doing this again with you sometime.

Christian Newton: Thanks, Tony.

Ep #07: Investing for Long-Term Success with Christian Newton

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