Generations ETFs episode 7: Mark Yamada interview transcript, recorded March 6, 2015

Welcome to Generation ETFs, brought to you by Horizons ETFs Management Canada Inc. This is a podcast series dedicated to the next generation of investing. I'm your host Donna Papacosta, and in this series, Generation ETFs will aim to educate and inspire investors to understand and be active in their portfolios by discussing market trends and investment strategies with the leading experts in the industry.

In this episode of Generation ETFs, you'll meet Mark Yamada, President and Chief Executive Officer of PŮR Investing, Inc. PŮR is focused on getting investors better and more personalized investing solutions. Mark is a pioneer in the use of exchange traded funds, a champion for individual investors, and always a challenger of the status quo.

In this conversation, Mark talks about why he supports ETFs as part of a portfolio, and shares his insights into risk targets vs. return targets, as well as the optimal frequency for rebalancing a portfolio. Be sure to listen until the end, when Mark reveals the valuable lesson his parents taught him about investing.

Donna Papacosta: Mark, as one of the first proponents of ETFs, why did you support *this* investment structure?

Mark Yamada: Well, I'd grown up really as an institutional investor. When I turned to look to see what was happening in the retail market, it was pretty clear that there was a deficiency. For all of the great things that mutual funds were able to do for the retail investor, when the ETF came along in its basic form it showed tremendous promise. What it did, was it did everything mutual funds did at a fraction of the price – professional management, diversification, shared expenses – and it added the elements of transparency, liquidity throughout the day, and it was a tremendous advance for the retail investor. That's why we really embraced it.

Donna Papacosta: Your focus is on ETF portfolios. What is it about ETFs that makes them a great vehicle for building a core portfolio?

Mark Yamada: Well it's interesting you phrase it that way: Building a core portfolio. Because when we first started to build portfolios with ETFs over a decade ago, we thought exactly the same thing; here are great elements for a core portfolio. They have built-in diversification, they will allow you to build a portfolio based on a benchmark that's diversified and that we felt that those benchmarks were really what was going to get an investor to their final goal.

So, whether it's 60% equities and 40% bonds, you could build a core that way and get there. But the development in the ETF market has been quite exciting over the past intervening 10 years. They've allowed not only for the core to be built, but for elements around that core to add enhancements and opportunities for growth beyond what we even anticipated 10 years ago.

And the research that we've done has shown that there are elements in ETFs that even the investment professionals have not seen before. The way individual securities work together when in a core, or the way individual securities and elements of those securities work within an ETF. There has been tremendous development over the past 10 years, so it goes beyond the core.

Donna Papacosta: Investors often blend stocks with ETFs or mutual funds. Is the best practice to have all three, or two of the three? What would you say?

Mark Yamada: Well my Economics 101 professor said that every answer should begin with “It depends.” Here is a really good case of “It depends.” One other thing we've learned, and one thing I've learned in my over 40 years in the investment business, is behavioral finance has a large part to play.

It's not so much ... Yes, everybody would like to have the best performing portfolio. But it's impossible to do that, so it really is what are you comfortable with? What do you have confidence with moving forward? If people have confidence in an individual security, I've always said, watch that security very carefully.

Forget about what people say about diversification. Just watch that individual security very carefully, and it will do the job for you. If that's what makes people comfortable that's terrific. The problem is most people are busy, and don't have the time to devote to an individual security.

Even as a professional, the one thing that was crazy was I would go and visit companies through the Midwest and I’d come up with an individual company that I really, really liked and the first thing that I did for a portfolio was I diversified away my exposure to it. It made no sense at all.

Then I learned that it's really the risk of the portfolio that gets you the return. Combining individual securities into a portfolio to diversify an element of that risk related to any individual investment and to give you exposure to a broad market in a diversified way was really the goal of all of this. And you can do that more handily with mutual funds and ETFs.

As I said, ETFs just made the whole idea of collective investing, cheaper, more efficient and more transparent. There are folks out there who will not now look at certain forms of investment because simply ... Because of the cost. It really comes back to the individual.

What are they comfortable with, what allows you to sleep at night, what elements in a portfolio will make you happy and confident moving forward? It doesn't necessarily have to be the optimal portfolio in terms of performance, but you have to sleep with it.

Donna Papacosta: The ETF portfolios you designed for Horizons ETFs are built based on risk targets rather than return targets. Why risk?

Mark Yamada: Two basic reasons. Number one: Risk is persistent. Today's risk tells us something about tomorrow's risk. If we use the VIX as an example – VIX is the option premium on the S&P 500 – if the VIX is 14 today, I can almost guarantee you it will be within 1.5 of 14 tomorrow. It has a daily auto-correlation of over .99.

So, it's very telling that tomorrow's VIX is based on today's VIX. In contrast, the auto-correlation of today's return on the S&P 500 is almost zero; it's .04. So while today's return tells us almost nothing about tomorrow's return, today's volatility tells us about tomorrow's volatility.

It's that risk related to volatility that's predictable. That's the first reason. It's predictable and we can work with it. The second is when we're looking to compound returns, risk is very important. The ability to control and manage the downside is almost more important than the ability to compound returns moving into the future. Those are the two basic reasons.

Donna Papacosta: Why did you decide to build your model portfolios using ETFs specifically? Is the risk more controllable than with other funds?

Mark Yamada: There's a bifurcated answer to that. Number 1 is: It depends when there are index based ETFs or mutual funds, the range of volatility is much tighter than if it’s actively managed. It's really based on the index nature of the underline that allows that risk to be fairly tightly controlled and predictable.

When we're building a portfolio, it’s like building blocks; you want the most solid concrete structure possible. You want to have the most confidence that the risk elements in those building blocks are as you have predicted them. ETFs offer that. They offer it in a way that institutions have been able to use them – groups of securities – for a very long time now. There are now available to the retail investor.

Yes, we would prefer to use the more stable, index-based ETFs for that core. There is a place for active management, but the risk of actively managed ETFs is a little bit wider, a wider band there, and a little more difficult to use.

Donna Papacosta: How does an investor decide on how much risk is appropriate for their portfolio?

Mark Yamada: It's really up to them, and it really depends on what they're going to use the money for. In our parlance, the two most important questions an investor has to ask themselves are: How long am I investing this money for? And number two: How much downside in any one year can I take and still sleep and not kick the cat and slam the door?

Those are really the elements that are most important. We've actually come up with a way using a risk based portfolio construction approach to be able to determine a portfolio based on the maximum downside. For example if the most you can lose is 10% in a given year, you pick a portfolio with the risk number of 10. What that really means is we're investing as though, it has an investing time horizon of about 10 years. The worst return you're going to get with a high degree of likelihood is you're going to get all your money back plus inflation with a 95% likelihood. It means also that the worst return is going to be -10% with a high degree of likelihood. This creates a return floor underneath the portfolio.

We think it's a much easier way for retail investors to manage their money moving forward.

Donna Papacosta: Mark, what is the optimal frequency for people to rebalance their portfolio? Should it be monthly, annually?

Mark Yamada: It depends. It depends on the method of portfolio construction. The most popular method is to select a set asset allocation, like 60% equities and 40% bonds. Then rebalance to that fixed mix. We have recognized that this is not the most optimal. It's a simple way, though. There is real benefit in rebalancing over time.

Our approach is we rebalance to the risk in the marketplace. When the risk changes, we rebalance so that the risk remains consistent through time. We've shown that we're able to lower the volatility of portfolios and increase the return. This is a more complex methodology; the model portfolios that we built for Horizons use this methodology. But for individual investors who are looking really to manage their own portfolios, rebalancing more frequently is better than less frequently. If you can do it daily, that's optimal but there's obviously a cost to doing that. It's really up to the individual, the amount of time they want to spend with their investment portfolio. At least once a year. Once a quarter for sure and more frequently if the market is going crazy. As I say, rebalancing to a fixed mix has its limitations. It is the most popular approach simply because it's easy; it's not the most effective.

Donna Papacosta: And to close, here is a question that we ask everyone in this podcast series. What is the best piece of investment advice you ever received?

Mark Yamada: Okay, I'm going to cop out here. There are two. The first is: There is no substitute for good material nonpublic information. The regulators won't like that. Because that means there is nothing better than good inside information, and it's an absolute truism in the business. There are two problems with that.

Number 1: It's very hard to get good inside information. Number 2: It’s illegal to use it. It is absolutely the single best piece of information I've ever received.

The second is compounding. Compounding not only of returns but compounding of costs. Here's a pretty good example. There's nothing more powerful than compounding. My mother and my father told me this when I was six, and opened my first bank account with $10 and showed me the two cents in interest that I received and they said, "That money is working while you're sleeping."

I said, "This is cool." That's part of the reason I got into this business. Compounding is very, very powerful. Here's an example of somebody who is saving for retirement. If you start saving for your retirement at age 25, and you have 40 years to invest from age 25 to 65. You put that $10,000 away. The $10,000 is almost doubling every 10 years. At the end of the 40 years, it's accumulated to $150,000.

Now that's the power of compounding. And that's at 7%, but it works on the other side too. If your fee is 2% of the $150,000 that you've accumulated at 7% fully $79,000 has gone in fees. 53%. This is 2% fees, 7% return. The power of compounding works on both sides. Controlling your costs is really, really important.

You can put to use the power of compounding on both sides of the equation, and one active thing that retail investors – any investor – can do is control costs. You don't know what the returns are going to be, but you do know what the costs are. If there is one thing that ETFs have been able to do for the retail investor is to reduce that cost.

Taking money out of the pockets of the fund companies, and the investment providers, and putting it back into your own pocket is the best thing that an investor can do. Compounding is terrific. Thanks, Mom and Dad.

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