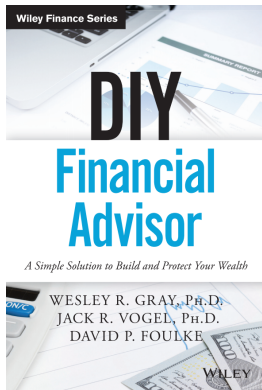


Author Interview: Wesley R. Gray

DIY Financial Advisor



After serving as a Captain in the United States Marine Corps, Dr. Gray received a PhD and was a finance professor at Drexel University. Dr. Gray's interest in entrepreneurship and behavioral finance led him to found Alpha Architect. Dr. Gray has published three books: EMBEDDED: A Marine Corps Adviser Inside the Iraqi Army, QUANTITATIVE VALUE: A Practitioner's Guide to Automating Intelligent Investment and Eliminating Behavioral Errors, and DIY FINANCIAL ADVISOR: A Simple Solution to Build and Protect Your Wealth. His numerous published works have been highlighted on CNBC, CNN, NPR, Motley Fool, WSJ Market Watch, CFA Institute, Institutional Investor and CBS News. Dr. Gray earned an MBA and a PhD in finance from the University of Chicago and graduated magna cum laude with a BS from The Wharton School of the University of Pennsylvania.

InvestingByTheBooks: Wesley, thank you very much for taking the time to talk about your latest book, "DIY Financial Advisor". Actually, there are three of you that have contributed to the book, so why don't we start there: Normally, writing a book is a lonely-wolf game until the end when editors and other support enter the picture. But here you "shared the burden" with two others who are also colleagues at Alpha Architect, the asset manager you founded. How did you divide up the work of writing the book?

Wesley Gray: This was my third rodeo when it came to book-writing and between running our business and interacting with clients it was going to be tough to do this solo. As far as delegation of duties, I outlined the framework for the book and focused on the first half, Jack focused on the back half, which involved the more technical details and data analysis, and David ensured that his 2 PhD co-authors didn't make the book incomprehensible and completely boring. In the end, it was a total team effort and a lot of fun to write.

IBB: Stepping back, how did the idea for the book originate?

WG: Our firm mission at Alpha Architect is to empower investors through education, so the book is essentially a direct extension of our mission. As far as developing the content, we have been writing about the concepts in the book via our blog for a couple of years and it was time to compile the knowledge into an integrated framework that was accessible to a broader audience.

IBB: Elbowing yourself into the somewhat crowded party of self-help financial books is perhaps not the easiest thing to do. What key message do you want to bring to the table and whom do you see as your targeted reader?

WG: Our basic thesis is that financial advice is opaque and too complex. We wanted to highlight that financial advice can be transparent and simple. However, in order to impress upon investors that simple and transparent advice is worthwhile, we need to educate folks that this is not a “feel-good” concept, but an “evidence-based” concept. Simple and transparent methods actually work better, on average, than opaque and complex ones. This is completely counterintuitive, because we often associate more effort and more complexity with better outcomes. So our book is the first to develop the argument for keeping things as simple as possible - but no simpler - from an evidence-based perspective.

IBB: Isn't it on the face of it a backwards idea that three academics and financial experts that manage ETF-based quant funds, write a book that extolls virtues such as simplifying down, avoiding experts, minimizing fees and so on?

WG: We actually hear that a lot since people are so accustomed to the traditional Wall Street pitch. Yet if you take a step back and consider what we're trying to achieve you'll see these traits are well aligned with the investor. We deliver affordable active solutions for tax-sensitive, independent, sophisticated investors. Much of what we build on the business side serves as tools for our segment of investor - especially do-it-yourself investors. We are very clear on our [value proposition](#) and for the segment of investors we serve (typically ultra-HNW and family offices), they find our transparent, evidence-based, process-driven approaches refreshing. In some ways, it's a complete inversion of what they typically hear from investment managers.

IBB: Your firm Alpha Architect state that your aim is “to empower investors through education”. Why do you believe that is beneficial?

WG: We believe an educated investor is a [sustainable client](#), which is critical for success in the long-horizon active strategies we develop. And we have 4 core beliefs:

1. **We believe in *Systematic Decision-Making*, not ad-hoc decision-making.** Disciplined and repeatable processes are more reliable than discretionary judgment.
2. **We believe in *Evidence-Based Investing*, not story based-investing.** Rigorous, data-driven research drives success; stories drive sales.
3. **We believe in *Transparency*, not black boxes.** We are committed to having investors understand what we are doing.
4. **We believe in *Win-Wins*, not unsustainable relationships.** We are committed to a business model that prioritizes client success.

We actually follow our mission and beliefs, which means we have no issue highlighting the benefits of simplicity (when possible), avoiding experts (when they add no value), and minimizing fees and taxes (when the expected benefits don't outweigh the costs). We feel our strategies and business offerings are in line with all of these beliefs, even though a knee-jerk reaction is “I'm not used to thinking this way,” or even, “this is weird.”

IBB: On the topic of wearing different hats, how do you reconcile teaching students about the efficient market hypothesis, optimal weights/efficient frontiers etc. in your role as a professor while running a firm whose success depends on its fallacies? What aspects about the Markowitz, Fama & French et al theories are still important to grasp, do you think?

WG: I have a long piece on what we refer to as [sustainable active investing](#). We outline the intellectual arguments for sustainable edge, while maintaining a healthy respect for the efficient market hypothesis and the extreme competition in financial markets.

IBB: A hugely important aspect that you bring up in the book is the difference between the “ignorant” (overconfident) expert and the “aware-of-his-fallacies” expert. This of course has implications in lots of areas of life outside investing as well. What can the DIY Investor do to tell the difference between the two?

WG: This is fairly straightforward in the end. Find experts who often say “I don’t know.”

IBB: Assuming an investor wants to come around to the solution you propose in the book, acceptance is often a long and winding road. As Step 1, what would be the single most important thing a person can do to avoid unnecessary losses (or getting sub-par returns)?

WG: As far as acceptance of a new philosophy/concept, the key is to ensure one is aligned on beliefs behind the philosophy. In our case, that means believing in transparency, evidence, and systematic-decision making. The second element is to understand the process that drives the investment strategy. The results will end up being what will be - and we can’t control results out of sample - the only thing we can control in real-time is the process we follow. And as it turns out, all of the worst investment blunders are caused by people focusing on past performance and not on process. Past performance doesn’t drive future performance; good processes drive past performance *and*, presumably, future performance.

IBB: Then there are those precipitous drawdowns that should or should not be part of one’s asset allocation...

WG: Well, as far as downside protection and avoiding large losses, we provide a fairly detailed empirical analysis and assessment of simple trend-following and absolute momentum rules via our piece on [downside protection](#). This is the only approach we’ve identified that has a fighting chance of preserving capital from massive drawdowns in the future. Who knows what will happen out of sample, but of all the concepts and ideas out there, this one is the best based on the evidence.

IBB: Do commodities really have a role to play in a DIY Investor portfolio?

WG: First, it is important to recognize that commodity futures are a highly misunderstood asset class. Here are 3 common misconceptions:

1. Commodity futures are **NOT** a play on commodity spot prices.
2. Commodity futures should **NOT** be considered an asset class, but a trading strategy.
3. Commodity futures do **NOT** deliver equity-like performance.

We discuss in [detail a real-time example](#) of a large asset manager highlighting their ignorance. We see this all the time. Not only do retail investors not understand commodity futures, but many professional investors are equally clueless - which is scary, because they are supposed to be the experts!

But back to the core question. Like all assets in a portfolio, the primary benefit of including a new asset is to enhance diversification and capture unique risk exposures. Commodities can be a useful element of a portfolio if one invests a bit in education and understanding how they fit in a portfolio. The downside of commodity exposures is they are more complex. In the end, if a DIY investor wanted to exclude commodities from their overall portfolio, I don't think it would create a major drag on overall portfolio risk-adjusted performance.

IBB: There is certainly a lack of momentum-based funds out there that are accessible for the small investor. This in spite of this factor's outstanding long-term track record, besting indices by 500-600bps annually. Why is that, would you say?

WG: Momentum is challenging as an investment product because it requires a lot of turnover, has limited capacity and has a lot of career risk for an asset manager (the strategy, while strong on a risk-adjusted basis, are insanely volatile). The other big challenge is the tax-efficiency. We're in the business of solving all these problems, but it requires structuring and finding those investors that are long-term focused and discipline.

IBB: What do you make of the fact that the momentum factor is considerably less successful outside the U.S. (to the tune of 200-300bps less vs benchmark)?

WG: I am unfamiliar with this evidence. Momentum is highly persistent around the globe. The one exception is Japan, but smarter versions of momentum (not the generic "2-12" momentum that was published in 1993) solve this problem. A friend of mine from grad school actually wrote a [paper on the subject](#).

IBB: What parts didn't make it into the book, except for more details (there are always more details...!)?

WG: Not much. The trick was trying to simplify and keep things shorter. We could have written a 1,000 page book as well, but that would have been too easy.

IBB: How do you invest your own money?

WG: I invest almost all of my liquid wealth in our own strategies. So do all of my partners. We build our strategies for our own investment purposes and to achieve our mission to achieve the highest after tax after fee risk-adjusted return over the long-haul (5-10 year +).

IBB: If you were to recommend one book to read, which one would that be?

WG: Danny Kahneman's book, Thinking, Fast and Slow.

IBB: Wesley, it has been a pleasure and very educational. Thanks

WES GRAY IN FIVE SECONDS

IBB: EV/Ebit or Price Momentum?

WG: Both.

IBB: US or All World?

WG: All world.

IBB: Mutual Funds or ETFs?

WG: ETFs

IBB: Markowitz 50/50 allocation or Van Hoisington one single zero-coupon bond?

WG: 50/50

IBB: Writing a new book or just focusing on Alpha Architect?

WB: Focusing on Alpha Architect and writing books to the extent they fulfil our firm mission to empower investors through education.

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