# Episode 4
# Have we considered what investors actually want? — with Lou Harvey

**Courtney Robb**

Lou Harvey, founder of DALBAR has been hailed for his contributions to elevating the level of excellence in the financial and regulatory industry. His interest has always been focused on understanding and protecting the highly individualized best interests of all investors. On this episode of Changemakers and Their Stories, I'll be speaking to Lou about what motivates him to continue wrestling with seemingly unsolvable problems, and also hear from him what the one thing is that he would change if he could change anything in the financial industry.

Hello, and welcome to Change Makers and Their Stories. I'm your host, Courtney Robb, Senior Strategist at Carpenter Group. Today, I'm going to be speaking with Lou Harvey, founder of DALBAR, the financial services leading independent expert for evaluating auditing and rating business practices, customer performance, product quality and service. Lou has also held a number of governance positions at institutions, including the National Association of Securities Dealers. And in 2010, he was named the President of the Fiduciary Standards Board. Welcome, Lou. I'm excited to have you on the podcast today.

**Lou Harvey:**

Thank you. It's my pleasure to be here, Courtney.

**Courtney Robb:**

You've spent the majority of your career fighting a number of battles in the investment community on behalf of the investor. But I want to begin with something I learned about you, which is that you graduated from college with a degree in physics. So what piqued your interest in developing a career in the investment world?

**Lou Harvey:**

Well, it certainly was a diversion in my youth, but started with a letter. I got a letter that said, "If you put your date of birth on here, we will give you a financial plan." So I responded, and then I met with this guy and he told me about these things called mutual funds. And he explained diversification, and he explained the opportunities there were in the capital markets. And I said, "This is for me." So immediately following that, I got registered as a representative and started my career in the investment community. So it all started with a simple direct mail piece.

**Courtney Robb:**

That's so interesting when direct mail was extremely effective in this case. Yeah. And it's interesting that you started as the investor, because some of the early battles you have fought have been focused on protecting the investor. And I think that's led to a lot of challenging the status quo and the way institutions have traditionally communicated with investors. So what was it that you were seeing, or maybe even feeling as an investor that was something that needed to be approached differently or needed to change?

**Lou Harvey:**

Well, if I sort of go back in time to answer the question, when I first was in contact with the mutual fund community, when I first learned about it, it was really a cottage industry. No other way to describe it. And then in the 1970s, it began growing. It actually became a mainstream investment. However, the mutual fund companies were not prepared for that level of business. And you know what that did for customer service. They couldn't answer the phone, they made errors. It was really a tough situation.

And that was how and where we started in this side of the business to try and measure and evaluate who is doing a good job, who is not, with a view that creating a level of competition in that world would actually improve circumstances. And I think it worked out pretty darn well, because today, neutral funds are probably among the eating providers of investor providers of services in the investor community. So it worked.

**Courtney Robb:**

Yeah. What were the big deficiencies that you were seeing? Was it just about the volume?

**Lou Harvey:**

Yeah. The volume translated to backlogs. The backlogs, translated to errors, and overall non-responsiveness. In today's world, if we have to wait for a half hour for somebody to respond to us, we complain. In those days, we were talking about weeks before you could actually get a response from an investment company about a question or a concern that you had. So yeah, it really presented itself in the form of an awful experience for the investor.

**Courtney Robb:**

And how has that changed in terms of what investor expectations are as things started to get better?

**Lou Harvey:**

That, I'm talking about a time before the internet.

**Courtney Robb:**

Where real time reporting isn't possible. Right.

**Lou Harvey:**

Exactly. The telephone was used occasionally, but the main method of communication was sending a letter. So it's really difficult to compare it. In a chat room, if somebody doesn't come on with you in two minutes, you're getting angry. So it's really difficult to compare those days to these days. And one of the things we try to do over the years is to keep the industries that we were working with at the leading edge of those kinds of interactions, to make sure that we focus attention on the things that are affecting the investor as those things change.

**Courtney Robb:**

Right. And so a lot of this has to do with performance and reporting. Is that correct?

**Lou Harvey:**

Oh yeah. Performance reporting is one of the things that we are working on most vigorously right now, because we see some major flaws in that area and have some concerns that they're actually hurting investors with some of the regulatory structures that are in place.

**Courtney Robb:**

In what ways are these regulatory structures hurting investors?

**Lou Harvey:**

The biggest issue, I think, is that millions of investors out there make decisions based on just one good year of performance. Just do it once and you'll get millions of investors rolling their money into your funds. This ignores all the prior history. So that you have an entirely different story if you look perhaps 10 years ago as to what the performance was then and then look at it today, that kind of comparison is not done anywhere.

The second aspect of it has to do with what we call persistence. And that means that if I look at some investment returns, how likely is it for those investment returns to persist? And before you decide that you're going to use that as your decision making tool, certainly, you want to know. You want to know if the 3.7% return that you're presented with this year is actually something that you can expect in the future. I mean, it seems pretty straightforward. And what would you think if I actually said it's in only 2% of cases does the performance of one year predict the performance of the next.

**Courtney Robb:**

Yeah, I guess that shouldn't be surprising.

**Lou Harvey:**

But people are making decisions based on that one year.

**Courtney Robb:**

Right. So how can you provide more accurate forecasts then, by using historical data?

**Lou Harvey:**

Yes. The two key issues there is looking at more than one period. In the last study that we did, we went back to 1928 and used-

**Courtney Robb:**

Oh, wow.

**Lou Harvey:**

... all of the returns since 19. And we used the S&P 500 there, but we looked at all of the returns since 1928, and found that they're very different from the returns in 2021 or the year before. So if one method is to go back in time and look at more than just one period, more than just the current period. The other key element that we worked on, I touched on before. And that is to look at the probability of actually seeing whatever that return is. As a matter of fact, one of the things that we found is that over time, if you look at 10 years, if you wait for 10 years, the probability of repeating that performance is better than the 2% that I mentioned before, but it only gets to 24%. It's still more likely for you not to have that return than it is for you to be able to rely on.

**Courtney Robb:**

Do you find that it's easier to predict returns or is it easier to predict investor behavior?

**Lou Harvey:**

It certainly is easier to predict investor behavior. That pattern is pretty consistent, but investor behavior doesn't make money by itself. Investors want to make money, so they want returns. And I'll give you another little statistic that I pulled out of our most recent work. We try to figure out the likelihood of the next period, the future period, being higher than the current period. Is it going to be higher or is it going to be lower? Believe it or not, it's 44% chance that it'll be higher and 56% that it'll be lower. What is that saying? It's more likely to have a decline in performance than it is to have an increase in performance.

**Courtney Robb:**

And you're looking at a period of 10 years. Why is that an accurate sample?

**Lou Harvey:**

Oh, it's not. It's not. We're looking at all of the period. We're looking at the one-year, three-year, five-year, 10-year period in all of the increments possible since 1928. So we're not looking at one, we're looking across the board. And that's why I think some of these numbers are so much more robust than the statutory disclosures of the most recent periods.

**Courtney Robb:**

Right. And so in doing this, you are trying to improve or help support the way investors make investment decisions. Correct?

**Lou Harvey:**

Absolutely. Two things. One is the way they make the decisions and the other is they have available to make the decision. You see, this information that I'm talking to you about comes from a study since 1928. That information is not available to investors if that were made available to investors, I think they would make decisions very differently.

**Courtney Robb:**

Yes. And I think it's also not just about having the information available, but the accuracy of that information. And as there are many ways to present performance, and it can be hard probably for the average investor to understand what the differences are. Even simple things like the gross or net performance of a mutual fund, and how does that impact my return.

**Lou Harvey:**

Absolutely. There's no question that it's a challenge to interpret it. And there's where the industry needs to get out in front of the public and begin to present this information in a digestible form, and come to some consensus as to what's really important information. I advocate that one of the most important pieces of information is the probability of investment returns being what this forecast. So if you're going to go out there and say, "This is what the return is," then you should have attached to that a likelihood. And if at the same time you're telling the investor, "Gee, there's a 5% chance this is going to happen," I think most people wouldn't tend to disregard it. They recognize that there's very little chance of repetition. So yes, the industry needs to fill in and come to some consensus as to what useful decision driven information is with respect to returns.

**Courtney Robb:**

Right. And so this persistent analysis forecasting that you have used as a method, you believe can depict, with better accuracy, whether or not performance is going to, as you say, go up or go down, or what percentage probability. And so what is it specifically about this method that makes it more accurate or makes it something that you actually can capture a percentage or probability of what will happen with returns?

**Lou Harvey:**

If I told you that something occurred just once, I think instinctively, you would know that there is some probability of it occurring again, but it's not a 100%. I mean, just starting with that. What we're doing here is we're comparing an event that's occurred just once, the most recent return, to 90 comparable events that occurred over the last, since 1928. So we're looking at it at a statistic that's based on one occurrence versus a statistic that's based on 90 occurrences.

**Courtney Robb:**

So it's properly weighting the factors that go into determining performance?

**Lou Harvey:**

Absolutely. You're not missing any important periods, which if I just look at the current period, then you would believe that 2008 never happened. You would believe that 1987 never occurred. And the big one in 1929 is lost. How can you make investment decisions when these major events aren't factored in and given an appropriate weight?

**Courtney Robb:**

Yeah. And I think that's a concern, I mean, especially with the pandemic that investors have. And some people that, whether we call them black swan events or these things that happen one time, they become things that a lot of investors think, "Well, you can't possibly account for that in predicting or forecasting."

**Lou Harvey:**

Well, but you can't ignore them either, Courtney.

**Courtney Robb:**

Right. So they're incorporated?

**Lou Harvey:**

Yes. You have to set aside a small probability. And what I'm saying is if you're looking over 90 periods and you have five bad ones, you are accounting for them. You're not ignoring them, but by the same token, they don't become the focus of your decision making.

**Courtney Robb:**

Right. You mentioned the financial crisis. So I think coming out of that, there were a lot of regulatory changes that were made. And I think a lot of those initiatives were to help investors have more confidence, I guess. In the market, there was a big distrust, there was mass sell-off, you recalled the history. So what was your perception of the way investor behavior was changing, but then also of how these regular initiatives were trying to address those investor changes?

**Lou Harvey:**

The best way to answer that, Courtney, is disappointment. My disappointment in the response to that is to look in the rear view mirror and not the look ahead at what the causes were and how those things could be avoided. It's fixing something without the context of the failure. So I don't think that it was particularly effective. You take a, for example, the two big to fail aspect, that was supposed to stop the problem. Well, the solution to too big to fail, wasn't the historical solution that has been applied in the financial services. It wasn't the Sherman Act that broke up very large institutions. It wasn't the Glass-Steagall Act that separated commercial banking from investment banking. What it was an arrangement among giant institutions as to how they were going to do business so that they could continue the practices that they currently had. So it didn't do anything.

**Courtney Robb:**

Right. And I think that created a lot of frustration among investors, just your everyday investors, seeing that there weren't repercussions, or there wasn't a strong enough look at what these institutions were doing and what saving the too big to fail did. And I know there's a broader economy that needs to be taken into account, but I do think that for the everyday investor, it felt completely defeating and disappointing, like you said.

**Lou Harvey:**

Yeah. You can add me to the list.

**Courtney Robb:**

Right. I mean, how does that change or how does that evolve, and do those feelings factor into investors' decision making today? Is there a kind of echo of that distrust still?

**Lou Harvey:**

It subsides over time. As we've seen in prior crises a year or two later, it becomes a memory after five or 10 years, it's a story that you tell your children about. So it goes away in time. And unfortunately, what I talked about before is that it's completely forgotten. It's ignored in the data. And that I think is the other extreme. That is unhealthy.

**Courtney Robb:**

I'm wondering, when you launched your study to discover what investors considered to be in their best interests, how did regulatory initiatives come up?

**Lou Harvey:**

Well, the regulatory initiatives was actually the trigger for it. What we discovered is that the underlying belief in these regulatory initiatives were that investment professionals, the attorneys, the compliance officers, or the institutions in the industry actually knew what every investor's best interest was.

**Courtney Robb:**

Right. There's obviously an inherent flaw in that thinking.

**Lou Harvey:**

Yes, I think so. Because I think my interests are a little different from yours, maybe.

**Courtney Robb:**

Exactly. Yeah. But they're making decisions or making initiatives based on that assumption.

**Lou Harvey:**

Exactly. And unfortunately, the problem is the investor doesn't have a say in that. So what I think is really important is to get that message out to the industry so that they can adapt their best interests policy, which is well intentioned, but implemented in such a way that it actually serves the investor's needs. It's not every investor that wants to beat the S&P 500. It's not every investor who fears a market decline. It's not every investor whose retirement goals are based on having the maximum assets in their 401k plan. Other people care about, "How is life in the meantime? How much can I forward to save?" These are all factors and examples of how people. And until the industry actually recognizes that, then the best interest concept is what I would describe as being blind.

**Courtney Robb:**

Yeah. It's interesting. As you're saying that, I was thinking it's the total wrong way to look at it. Because I was thinking, is there anything we actually can say every investor does want? I mean, does one similar thing apply to all investors? And I don't know that it does.

**Lou Harvey:**

It does not. In the study that we completed a couple of weeks ago, it does not. The breakdown in different categories screams at that. In fact, the biggest surprise in that study is how similar men are to women in their preferences. So take that off the table. I'm not talking about Venus or Mars.

**Courtney Robb:**

Right. I mean, that has evolved obviously in the last 20 to 30 years, but still today, people say, "Oh, well, women invest differently than men invest." And it's nice to see that is neutralized through your study.

**Lou Harvey:**

Yeah. The big differences though has to do with things like income levels and the assets that you have. And the family, the single person is very different in a host of ways from the family of three or four. The other huge variable in this equation that is not taken into consideration in today's world are the other benefits that are available. For example, if at your job, you have life insurance and health insurance, then your investment profile may not consider those things as being particularly important because you already have them. If on the other hand you don't have them, maybe those are number one and two on your list.

**Courtney Robb:**

Right. Exactly.

**Lou Harvey:**

So it is clear from the work that we've done that there's a vast difference among investors.

**Courtney Robb:**

So whose job is it to protect the investor?

**Lou Harvey:**

Oh, you're talking about finger pointing, Courtney.

**Courtney Robb:**

Well, not-

**Lou Harvey:**

Is it mine? Is it yours? The truth of the matter is that the structure is so complex as it stands today. The real question, I think, is going to be who is going to champion the cause for the investor? It's not, who's responsible? Because you could point almost to anybody and say that they're responsible. And by the same token, they can prove why they're not. I think of it as more proactive. It's asking someone to stand up and join the force that is acting in the investor's best interest and make it something that is a goal for institutions to pursue.

**Courtney Robb:**

Well, you've been doing it your whole career, so I'm interested. Many people find that being an outlier challenging the way things are done is a really uncomfortable position to be in. But you have championed the investor your entire career and it hasn't always been in keeping with what the status quo is. So I'm wondering, do you see yourself as a disruptor and is it an uncomfortable or comfortable position for you to be in?

**Lou Harvey:**

I have scar tissue. I have grown used to it. No, almost any of the initiatives that we've started, that we've got really engaged in has its distractors. And that comes with the territory. There is somebody who's going to be upset that I screaming bloody murder that we should act in the best interest of what the investor thinks is the best interest. That's a crazy thought. And I assure you, I will have criticism for it.

**Courtney Robb:**

What would you say the reason is that's motivating your drive to continuously fight this battle on behalf of investors?

**Lou Harvey:**

One win after 10 attempts gives me the motivation. So the fact that I've had an occasional win, the fact that people have had "ah-ha" moments, the fact that many in the industry actually agree with some of the positions that I've taken or the things that I've suggested and recommended, that's the reward. That's the motivation. It's the little successes that translate over time into major change.

**Courtney Robb:**

And it all started with some mail that was advertised to you, basically?

**Lou Harvey:**

Absolutely.

**Courtney Robb:**

That's incredible. I'm wondering, throughout your life, have you seen or looked up to somebody that you would consider is a change maker, and has that provided any sort of an inspiration for you? Not to follow in anyone's footsteps, but just to be kind of forging ahead as this outlying voice of, "Hey guys, let's look at this differently and, why aren't we thinking about it in a new way?"

**Lou Harvey:**

Yes, I do. And if you go back in history and look at the major changes, almost invariably, you will find that there was a motivating force. There is somebody out there who was fighting that cause. And those are the people. It's not one particular individual for everything, but each cause has its own agent. Start with the Securities Acts in 1933. I forget his name right now, but there was somebody who really pushed that. Dared look at the industry in the face and say, "You're doing things wrongly, and we ought to regulate you. And we ought to create an agency called the Securities and Exchange Commission."

That happened to have been a political action, but there are lots of other things. There are folks, I recall, 40 years ago when somebody came to me and suggested, "Hey, why don't we find a way to transfer the tax advantages of municipal bonds into mutual funds?" And so was born the muni bond fund, which is pretty routine today. Look at ETFs. There's another one that was introduced and took off. So yeah, all of those changes, all of those new innovations that we've seen had at its very core, its very beginning, the people that I think of and the people who drive my own motivation.

**Courtney Robb:**

Oh, that's great. And I think, you mentioned, I don't think ESG is a new invention, of course, but it is a topic that investors continue to pay increasing attention to, and the standards of ESG have been constantly moving and evolving. And ESG ETFs are available. And I'm wondering what you find important about ESG standards or how they should be addressed and incorporated into performance. Because there is a lot recently that says, "ESG companies with a high rating, they do perform better."

**Lou Harvey:**

Yeah. There are few different areas in the questions that you raised. One is the quality of ESG evaluations, where one company will have one view of what ESG is or what a good ESG arrangement is, and another company will have a somewhat different one. So there is inconsistency out there. I think that'll sort itself out in time, it will evolve into some kind of uniform standard.

The second thing that you mentioned has to do with the effectiveness of ESG. Does the sustainability really predict forecast long term performance? And there is strong evidence that it does. That if you are saving for retirement after having worked for 45 or 50 years, you probably don't want a short term investment. You're going to want something that's going to be there throughout your career. And so sustainability, I think, is an important factor and is probably understated in promoting ESG.

The third thing that I want to mention here is retirement plans. Now, retirement plans, in many cases, have more hits than the company who sponsors them. They're a huge market. And to date, the only effort has been to use the retirement plan as a asset gathering tool for investment managers. The actual practices of the retirement plan, the actual activities of the retirement plan to date have sort of gone under the radar.

**Courtney Robb:**

Meaning the governance of retirement plans? Is that what you mean?

**Lou Harvey:**

If a company has ESG policies and practices for that firm, they generally do not have practices, ESG practices, for their retirement plan.

**Courtney Robb:**

Oh, interesting.

**Lou Harvey:**

This company may be going "gung-ho" on paper. "We really want to eliminate paper. We want to do electronic communications, save the planet, save, reduce paper." But the retirement plan is still presenting all of the information on paper, whether people want it or not. It's ignored. The social side of it, it's the same thing. So what we're saying here is we want to change that view. We want to include retirement plans in the ESG spectrum. And not simply as a repository of funds, which is important, but the fact that the practices within that plan should conform to ESG standards. If a company, if an institution is going to be practicing ESG, then it should also encompass their employee benefits.

**Courtney Robb:**

Right. And in doing that, you provide more transparency to the investor so that an investor who does care about ESG would be able to make an informed decision about where their money is invested.

**Lou Harvey:**

Absolutely. Oh, yeah. And people care deeply about ESG. And therefore, they ought to be informed. They shouldn't be given half the picture. Yes, the company's doing this, but for the retirement plan, you're on your own. It's an anomaly that we're trying to fix.

**Courtney Robb:**

Right. And it's also the anomaly you're fixing within the way performance is reported and viewed. It's like you're doing the same exact thing. You're trying to apply a set of standards so that what investors are looking at is at least the best information and the most information possible.

**Lou Harvey:**

Yeah. It's reporting on the accuracy of the information, if I go back to the performance side. If you can tell me how accurate or how reliable your information is, that's enormously valuable. Don't just tell me 3.2%. Tell me 3.2% with a 5% probability of getting that right. I mean, or 3.2% with a 90% probability of getting it. It changes what you do on how decisions are made.

**Courtney Robb:**

And it does seem pretty intuitive of when you present it that way. So I'm wondering, what challenges are you facing? What are people responding to, or I guess, not responding to?

**Lou Harvey:**

Oh, well, it's the traditional, "This is the way we've always done it." That's the single largest hurdle-

**Courtney Robb:**

Right. There couldn't possibly be a better way out there.

**Lou Harvey:**

Yeah. But when your career is based on how it's always been done, you tend not to want to put your next raise at risk.

**Courtney Robb:**

Right. I guess you've had a pretty successful career though, basing it on how to change what's always been done.

**Lou Harvey:**

Well, I've had wins and losses. Got to admit that.

**Courtney Robb:**

Well, if you could have one win today, or if you could change one thing today, what would it be?

**Lou Harvey:**

The most passionate thing I have on the agenda, frankly, is for the industry to actually turn to the investors to find out what their best interests are. I think that's probably the most important correction that the industry could make. Because out of that comes a lot of other stuff. Out of that comes ESG. If you go ask the investor, if investors says, "I want ESG," you're moving towards the direction of the investor and you better respond with ESG. If investors ask for predictability of returns, it says you need a better method of predicting investment returns, and you tell me which investor is not interested in some kind of prediction of what investment returns are. Everybody is. So, if you're going to act in the best interest of the investor, then surely you need to reach out and really let them know, honestly, as best you can, what you project, what you forecast, and how accurate that forecast is.

**Courtney Robb:**

Right. And I think that seems to reflect the way we as humans make any decision. You just think, “What are the chances of this happening if I do X?” And right. Weighing a decision, invariably involves looking at the probability of something happening or not happening or looking at the probability of a potential outcome. But I just wonder why people are resistant to include that in the way we look at and forecast performance. It just seems so intuitive.

**Lou Harvey:**

I don’t know. Other than saying, “This is the way that it’s always been done,” yeah. It is. People are familiar with it. Have you ever watched a weather forecast? It always comes with, ”Well, there’s an X probability of,” Blank. Rain. Storm. Whatever. A sunny day.

**Courtney Robb:**

Right. I mean, I have like three apps on my phone. All of them say something different.

**Lou Harvey:**

Fine, but that is a lot more useful than if it didn’t have that number.

**Courtney Robb:**

Oh, absolutely. But yeah. Even that is hard. But if we can figure out how to predict the weather, wow. We could solve all the problems. We could predict everything then.

**Lou Harvey:**

Right. That’s true. Yeah. If you can figure out the weather, investments would be a cake walk.

**Courtney Robb:**

Piece of cake. Yep. Well Lou, thank you so much for joining us on the podcast today. It was a pleasure to talk to you and I am in admiration of all of the work you do, as are many of the Carpenter Group team.

**Lou Harvey:**

Well, thank you very much. I really appreciate it and I love the opportunity to chat.

**Courtney Robb:**

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