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On this week's program: Why index investing is best for most, but stock picking reigns supreme for some with Motley Fool co-founder Tom Gardner, who has a track record to prove it.

Tom Gardner
Co-Founder
The Motley Fool

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CONSUELO MACK: This week on WEALTHTRACK, The Motley Fool's stock advisor portfolios have beaten the market over the years, but Co-Founder Tom Gardner says for most of us indexing is the way to go. What's best for investors is next on Consuelo Mack WEALTHTRACK.

Hello and welcome to this edition of WEALTHTRACK, I'm Consuelo Mack. We have been receiving many emails from viewers recently about the merits of passive versus active investing, a topic we have been covering over the years but more frequently recently, as more research comes in. A lot of people threw in the towel on active when they heard the results of the latest "SPIVA" U.S. Scorecard report from S&P Dow Jones Indices. Here is a 15 year track record for domestic equity funds. As the report notes "The longer time horizon provides a complete market cycle to measure effectiveness of managers across all categories." The figures were stark: 92% of large-cap U.S. stock fund managers, 95% of mid-cap and 93% of small-cap managers trailed their respective benchmarks.

The comparisons didn't improve when you traveled overseas either. The majority of managers across all international equity categories underperformed their benchmarks as well.
Another stunning trend was how many funds disappeared over the 15 year period. More than 58% of domestic equity funds were either merged or liquidated and almost 52% of global/international equity funds were.

Is the case now closed? Does passive win? This week's guest is a successful, market-beating active manager who believes passive is best for most but active rules for some, especially those attracted to his Motley Fool investing community. He is Tom Gardner, CEO and Co-Founder with his older brother David of The Motley Fool which they started as a small printed newsletter for family and friends in 1993, turned into a website, the Fool.com in 1994 and is now a global multi-media financial services company offering research and advice to millions of individuals through its website, podcasts, newsletters, books, columns, and wealth advisory services. Their stated mission is "To help the world invest better". Their *Motley Fool Stock Advisor* newsletter portfolio, has crushed the S&P 500 since its 2002 inception with 17.8% annualized total returns vs. the market's 7% returns.

It combines Tom's more conservative value approach and David's swing for the fences growth approach. Both brothers believe in investing in great businesses with strong financials, managements and cultures. Motley Fool itself was ranked the "Number One Place to Work In The U.S. For Small and Medium Sized Companies" in 2014 and 2015.

I began the interview by asking Gardner why his first piece of advice for new Motley Fool investors is "Buy an index fund!"

TOM GARDNER: Well, because I think it's the greatest financial offering that's ever been created. I mean I believe that Jack Bogle has probably had the biggest impact on investors of

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any person in human history, far greater than Warren Buffett's impact, and I'm a huge Warren Buffett fan obviously, but the size and scope of what Vanguard has created and other indexing alternatives that have come after is awesome and transformative, and it's the cheapest way, the most tax-efficient way to get exposure and diversification in your portfolio.
So it's a great place to start, and even though it could stop you from doing business with The Motley Fool, we're the first ones to say if you want to end there, if you just want to index, that's great, and we have fulfilled our purpose of helping the world invest better by getting you into that great solution first.

CONSUELO MACK: So for many people, again quoting you, "active investing is not worth trying even." Why isn't it even worth trying for many people?

TOM GARDNER: Well, many people aren't interested in the subject, so that would be the first reason. Many people just this is like dental work to them more than a great adventure in learning and understanding business and capitalism and how to allocate capital and manage risk and learn about your temperament. For many people this is something they're not actually doing. So a number of people are going into retirement with far less money than they're going to need, given medical technology and how long they could live. So I'd say if active investing requires that you spend time and think about things, for many people that's not a good approach.

CONSUELO MACK: So what is better about buying an index fund, especially considering that everyone else is doing it now too? One of things, that great investors are usually contrarian thinkers, they're independent, so here you are saying do what the herd's doing.

TOM GARDNER: It's pathetic really.

CONSUELO MACK: It is pathetic.

TOM GARDNER: There's no intellectual curiosity to it at all. I'd say that the number one reason is because the fees are so low. So when you're going to actively manage funds, you're paying 50 basis points, 100. You're paying one percent per year let's say on that fund. Those funds are trading well more than 100 percent of their assets each year. So you're getting tax hits that are not published and should be. Mutual funds should be required to publish their after-tax returns for people so that we could see what's really happening there. So the index fund, I mean it's essentially like what Amazon is doing to the retail industry. That's what's happening. Sure, you can have some more colorful experiences by getting in your car and driving out to a store and all the rest, but you get a broader selection. You get better convenience. You get lower prices. You get home delivery from Amazon, and that sort of convenience is what Vanguard is doing to the financial industry.

CONSUELO MACK: One more question as far as what's happening with the indexing. If you look at this year for instance, 53 percent of the gains in the S&P 500 were driven by five

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stocks, and the stocks, they're all tech stocks, and they're Apple, Alphabet, Microsoft, Amazon and Facebook. So they accounted for 53 percent of the S&P 500 gains this year. That is concentration. Does that concern you?

TOM GARDNER: Well, I mean at first it feels good, not to hug myself, but at The Motley Fool we've owned a lot of those stocks for a very long period of time, and you know that our orientation is to buy stocks and hold them for five to ten years. So they have been great investments. Do I think that those are the great investments of the future? The next five and ten-baggers that somebody can put in their portfolio and sit back and enjoy? I don't. Do I think that they're going to be poor performers over the next five to ten years? I don't think so, but I don't think these are the great investments of the future now because of the size of those businesses. So it is concerning. Anytime there is concentration like that, it is concerning. There is also with that concern correspondingly a tremendous amount of opportunity in small cap companies in the U.S., forgotten, left behind, well-run small businesses. Some of them will become the eagles of the future that soar and become ten billion, 15 billion, 20 billion dollar companies, but some of them are market caps 750 million, and they'll be four times more valuable in seven years, and that's a really, really great investment. So I think small caps and I think getting outside the U.S. are really intelligent moves at this point, but I wouldn't be cashing out of my great U.S. tech companies. I don't want to pay those taxes, and I think those businesses are well run and will continue to become more bond-like and dividend paying-like than great growth investments of the future.

CONSUELO MACK: So Facebook is one of the largest holdings for Motley Fool? Is that right?

TOM GARDNER: In the portfolio I manage, the Everlasting Portfolio for Motley Fool, it is about a 12 percent position, and of the companies you named Facebook is my favorite at this point. We started buying it below $25. We've been adding all the way up. Here it is north of $140. It's about a $400 billion market cap. In general I don't like to have very large positions in large cap companies with above average multiple of cash flows in the valuation, but my bet is that Facebook will become the first sustainable trillion dollar market cap.
There may be other companies that sort of touch it, move above it, but Facebook is completely dominant in social connections around the world. The social connections we have online actually are somewhat addictive. I mean there's almost like an addictive caffeine-in-the-morning type relationship that people have with Facebook that they have with Starbucks. I think that's going to be pretty impenetrable, and with Mark Zuckerberg you have somebody who 20 years from now will be Jeff Bezos' age. So he's the dominant voting control leader of that business who's going to be there for a long time.

CONSUELO MACK: Talk about that, because one of the things that you focus on at Motley Fool in buying companies is that you think that an entrepreneur-led company is a really good thing. Why would you favor entrepreneur-led companies?

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TOM GARDNER: Well, if you look at the data, owner operated businesses in the public markets outperform the market by a couple percentage points per year, and that's a huge gap. I think there are a couple good reasons for that. First of all, most of the founders that are CEOs of public market companies have long since made more money than they need. So why are they still going to work? If many people were given the opportunity to walk away from their job because now they're worth $50 million, I think unfortunately most people would walk away from their job. What we have in the leaders of owner operated public companies are people who are so passionate about what they've created. They're putting their entire professional life behind it. So I'm not big on professional management. I don't like the agent operated companies where somebody comes in and gets stock options for four or five or six years, and toward the end of that tenure, the fifth or sixth year, that CEO starts acting like a venture capitalist who has an out that they have to optimize quarterly earnings to try and get the stock as high as possible and pass the mess to the next person. I want Howard Schultz who's there indefinitely.

CONSUELO MACK: Starbucks.

TOM GARDNER: I want Tobi Lütke at a company called Shopify who I think is going to be there for an extremely long time. It's a small cap. It's been a great stock over the last couple years. So I really like the ownership mentality that I think a founder brings in the public markets and, gosh, I think if you just indexed off founder-run companies in the public markets, you're going to do very well.

CONSUELO MACK: Is there an index like that yet?

TOM GARDNER: There are funds that are out there. Of course we prefer The Motley Fool approach of buying the stocks because in general I don't wan to pay an annual management fee. One of the things we do at The Motley Fool is contact leadership of every company, and for the most part now, 20 years in to being Fools out there in the world, some people have heard of us and we generally get an opportunity to sit down, and so I'm talking to the founders about their business, about their industry, other great companies in their industry about how they run their company and ways that we can learn at The Motley Fool in how we run our business. So I would not be interested in investing in a founder-led index fund or any index fund. I've never owned an index fund even though I think it's the best first investment for people.

CONSUELO MACK: At Motley Fool your mission when you started in 1993 and launched MotleyFool.com in 1994 was to help make people better investors and help make yourself better investors. So 20 some-odd years later, has it worked?

TOM GARDNER: Well, I think that we share that mission. I think that your work ...

CONSUELO MACK: No, we do absolutely, WEALTHTRACK.

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TOM GARDNER: I think you're making an impact, and I think we're making an impact. There are a lot of forces that work against it, whether it's financial media that's more interested in the stocks of this week to buy or stocks in the month of May over the last five years. These industries have done well if you're just going to hold them for the month of May, so all of that noise and all of the transactional nature of Wall Street. There's a lot of momentum in those zones that's hard to counter. At the same time, I think through the work you're doing, through the use of the Internet, the ability to create communities where people can learn and understand a subject they weren't taught in school unfortunately, I do feel good. I mean I still think of our company as being in the bottom of the second inning. I don't think we're taking a victory lap and we've done really well. I think we've achieved some very nice things. I am proud that in our 1996 book which we've already talked about ad nauseam here, but we advocated using the index fund as your first place, and very few active managers talk about that. Most active managers were mocking indexing or they felt threatened by it. In our case it's, hey, that's the foundation, and now let's try and beat it, but let's be totally transparent. Let's look at how we do after fees, after taxes and see if we can do better than average and hold us accountable, and if we can't, don't subscribe to our services. You shouldn't be paying us. So thankfully we have, and I think I see the light bulbs going off in more and more people's minds to look at investing as their portfolios of business, and if you're entrepreneurial to find ways to get better returns by being curious, learning and learning from the masters.

CONSUELO MACK: So Tom, building a stock portfolio, what's your goal in building a stock portfolio?

TOM GARDNER: Well, my personal goal ...

CONSUELO MACK: What are you trying to do and what are you trying to do for other Fools, for subscribers?

TOM GARDNER: I'd say it starts with the performance, but it's not performance over six months or a year. I mandate it . I placed that rule on myself of holding all my investments a minimum of five years. And many of my stocks I'll hold 10, 15 years. You start to accept these business will see the valuation get dunked 30 to 40 percent a couple times each decade. It's going to happen. It happens to Berkshire. Starbucks is up 23 percent a year since 1992, but multiple times the stock has been down 50 percent. 2008, 2009 it was down more than 75 percent. So in my view, to build a great portfolio, you have to set it up so that you can have those 50 percent price cuts even though the business is continuing to function well.

CONSUELO MACK: Five years minimum?

TOM GARDNER: Five years minimum, so some losers we have trail on, and I kind of wish we could sell them in year three or four, but the discipline of learning from those businesses

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and not putting your mistakes in the rearview mirror and forgetting that you shouldn't have bought shares of a company that has a big private equity owner running that company in the public markets.

CONSUELO MACK: So you actually will hold onto stocks just to make the five year that you're not that interested in?

TOM GARDNER: There's a great investor in our community named Tom Engle who says you should never sell out of any position entirely. These are stories. If you're here to learn, these are stories, and why close the book at chapter seven just because things were working well for you? Let's see if the management can turn that around. Let's see what happens over the next 20 years, and let's learn the lessons of how they're making those decisions to right the ship. So yeah, I'd prefer to never sell any position, and Warren Buffett's data shows that had he never sold a stock since the age of 11, he'd have substantially more money and Berkshire shareholders would be better for it.

CONSUELO MACK: So would yours and David's portfolios if you had never sold any stocks. I remember that the performance would have been even better. Right?

TOM GARDNER: The mathematics of that is that human nature, I mean the basic psychological research shows the pain of loss is three times the joy of gain. So we remember our losers. We feel our losers. We hate our losers, but even great investors are going to be wrong three or four out of every ten investments. Either they won't beat the market or they'll outright lose money.

CONSUELO MACK: So what have been the biggest losers?

TOM GARDNER: Well, Fitbit hasn't been a good one recently.

CONSUELO MACK: Fitbit.

TOM GARDNER: Fitbit hasn't been good. There are some great things that Fitbit brings to the table, but overall nobody's really cracked the code on the smart watch, and nobody's really cracked the code on wearables yet. There's a lot of buzz about that, but for the most part ...

CONSUELO MACK: But you're sticking with it.

TOM GARDNER: ... people put the Fitbit watch on, wear it for three weeks and then forget where it is, and that's kind of what happened to me with my Fitbit, but I continue to hold it.

CONSUELO MACK: And to me too.

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TOM GARDNER: I continue to hold it and learn from it, but the beauty of our losers is that every day that they lose they're becoming less and less relevant in our portfolios. So your losers and my losers are probably one half percentage point positions in our overall portfolio. Even if they doubled they're not going to be consequential.

CONSUELO MACK: So one of the things that you tell Fools when they're ready to sign up for The Motley Fool, one of the services, is to expect that it's only, what, ten to 15 percent of the portfolio is going to drive 80 percent of the performance. So you're holding "a lot of losers," or at least you're holding a very small amount of winners that are going to make the difference.

TOM GARDNER: That is really true if you have the time horizon that we have. So if you're holding stocks a year, you're not going to have those breakouts, but if you buy shares of Facebook or you buy shares of a company that I love, Arista Networks, and that business goes on to compound above average returns for 15 years, that is going to grow particularly if you add at points along the way. That's going to grow to become a larger and larger position in …

CONSUELO MACK: Talk about Arista Networks. What is Arista Networks?

TOM GARDNER: Arista Networks is such a beautiful story and a unique story. It's a Silicon Valley-based company that's competing with Cisco. It's software-defined networking, so they're allowing us to access Netflix on mobile devices, whereas Cisco had really built all their networking technology up around desktops and having servers in physical locations. So this is a cloud company.

CONSUELO MACK: Next generation.

TOM GARDNER: Here's the beauty of the story though. They built their business for four years without launching a product. They self-funded it. They never took any venture capital money. When they went public, insiders owned more than 50 percent of the business; very unusual in Silicon Valley. One of the founders, Andy Bechtolsheim, was the first investor in Google. He wrote $100,000 check to Larry and Sergey. He's one of the founders of Sun Microsystems. So they have incredible people, and I sat down with Jayshree Ullal who's the CEO of Arista Networks, and she's one of my five all-time favorite CEOs, and when you asked me earlier, what are you trying to do when you build a portfolio, a very personal answer for me is I'm trying to learn more about the world. I'm trying to invest in companies that are going to teach me something about where the world's going, how to lead, how to think about risk management. So if I'm looking at Arista Networks or Starbucks or Facebook, I'm wanting to meet the leaders of these companies as much as possible. Learn how they think and learn how to find more people like them leading businesses. So I'm much more interested in investing in entrepreneurs than I am in stock valuations or financial metrics or stock filters that you could run online.

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CONSUELO MACK: Take us a little bit into the small cap universe, how you're investing in small caps, and you need a lot more of them to make an impact in your portfolios. Right?

TOM GARDNER: When looking at small caps, the first factor I look at beyond whether it's owner operated is the top line growth rate. If you're going to get a great long-term investment, you need customer demand. A business that's growing the top line at four percent with a market cap of $600 million, it's hard to imagine how that's going to become a $6 billion company over a timeframe that would make it an attractive investment. So I like businesses that are growing the top line 20 percent, 30 percent, 50 percent. If you look at, mention Starbucks or a great company like Whole Foods, if you look at those businesses during their first ten years in the public markets, their average sales growth rate per year is like 35 percent a year for a decade.

CONSUELO MACK: Wow.

TOM GARDNER: So many value investors would not even allow that possibility that a company could grow at that rate, and many short-term traders wouldn't even look to think that that would matter, and that creates the inefficiency in the market to be a ten-year holder of a great small cap growth company and to look for, wow, people love what they're selling right now. If it's sustainable with a great culture and a great founder running it, this could be a great stock.

CONSUELO MACK: So owner operated, revenues have double digit or you said 20, 30, 40 percent. What's the other criteria?

TOM GARDNER: Another more qualitative almost. I mean there is a measurable way online with services like Glassdoor. I like to see, how is that culture developing? What do employees say who are working there? I don't believe in shareholder activism. I don't believe in looking at just one stakeholder and thinking, gosh, this is what it's all about. Or if they just succeed here, everything else will be fine. I like to find very balanced companies, so I'm not particularly enthusiastic about what's happening to a company like Whole Foods right now with shareholder activists coming in. I'd like to see stakeholder activists.
I'd like to see somebody come into Whole Foods and say, "Hey, how can we make sure employees, customers, shareholders, all the communities they operate in, that they're all going to be lifted up?" and I find founders generally have that reputational desire to see all stakeholders lifted for a host of reasons.

CONSUELO MACK: But activist investors don't really care about that.

TOM GARDNER: They don't care at all.

CONSUELO MACK: They didn't pay attention to this, they just want to pay attention to the

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shareholder.

TOM GARDNER: Exactly, and they're going to take a couple-year time horizon, and they're probably going to lay off a lot of people, and they're going to split the business up in different directions. So there's a big fragmentation process that goes on with shareholder activists and private equity firms. Not all of them, but most of them in that system I don't think are real value creating for society. So I want to find a great culture. I want a business that's growing with a founder who's there working every day, passionate about the mission of that business. People love coming to work. They're going to be the ones that are driving value for customers.

CONSUELO MACK: Motley Fool ranks very high in the Glassdoor surveys I might add.

TOM GARDNER: Well, and why do we? Because we sit and study these great companies and take their ideas and employ them and test them. Then if there were another factor I'd just say of course I want to see cash flow growing. I'm not really that interested in income statement earnings. I'm much more interested in owner earnings and looking at the cash flow of the business, depreciation, amortization and putting it in the context of the capital expenditure investments that they're making and really understanding are they getting rates of return on their investments that are above average and that can be reinvested. Right?
You can have a great two-year period or three-year period, but is there a large enough market opportunity that this great CEO, she's going to be able to keep deploying capital in this for the next five, seven, ten years, and everyone loves working there. I'm just going to ride. I'm going to get on their airplane and I'll pretend that I'm the one steering it. I'm going to sit 20 rows back and put my headphones on and hopefully watch a great movie and let them run the business that I'm invested in and accept that sometimes we'll have some rocky landings and investments that don't work, but we're going to find some great companies with that methodology.

CONSUELO MACK: International space. How are you approaching finding great international small caps?

TOM GARDNER: Same criteria company by company, and then you look at the marketplace and see which markets have really not been keeping up with the U.S. equity performance..

CONSUELO MACK: Final question, Tom, one investment for a long-term diversified portfolio. We should never put all of our eggs in one basket, but...

TOM GARDNER: Put them all in this basket. No.

CONSUELO MACK: So what's a great investment do you think?

TOM GARDNER: I thought of a small cap that's in Oklahoma City, Oklahoma, Paycom

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Software. It's an investment that we have recommended at The Motley Fool. Ticker symbol is PAYC. It started as a payroll processing company that's software as a service, so it's the SaaS model of paying a subscription for the tools that they're developing. In this case small and midsized companies are paying to get payroll processing now, human resources and talent management and other tools so that you can run aspects of your culture as a small and midsized company based on the tools that they're creating. You're paying a subscription for it. They're founder led. They came public. I think they were founded in 1998. They came public a couple years ago. It's been a great stock already. And this is really a David Gardner, my older brother's principle which I've realized over time is so right, and that is we should really be looking to add to our winners and not ... of course we want to find the company before anyone else has and ride it all the way up, but in many cases stocks have already doubled and tripled, and you might be sitting there thinking how could I do that? Nowhere as a consumer do I want to buying something that's three times more expensive than it was 18 months ago. So it's very hard to get our minds around that, but that is not always but often an indicator that that business is thriving.

CONSUELO MACK: Tom Gardner, such a treat to have you here on WEALTHTRACK. Thanks so much for being with us.

TOM GARDNER: Thank you.

CONSUELO MACK: At the close of every WEALTHTRACK we try to give you one suggestion to help you build and protect your wealth over the long term.
This week's Action Point is: **Pay attention to the culture of the firm's you invest with.**
Do they act as fiduciaries and put their clients' interests above their own?
Do they have a clearly stated mission and investment objectives?
Are they committed to disciplined investing for the long term. In other words, are they built to last?
Do they pay attention to costs?
Are they honest about their mistakes and humble about their successes?
Whether passive or active you want to invest with top-quality firms dedicated to investment excellence and client interests.

Next week, we will sit down for a rare interview with leading Wall Street economist Nancy Lazar to discuss the state of the economic recovery, now on of the longest on record. What's the outlook?

In the meantime to see more of our interview with The Motley Fool's Tom Gardner, please visit the EXTRA feature on our website. And tell us what you think on Facebook and Twitter.
Thank you for watching. Have a happy Mother's Day weekend and make the week ahead a profitable and a productive one.

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