Mullooly: Hello everybody, in this episode we're going to talk about, what happened to the Dow Jones back in August? Why did the market fall a thousand points one morning? We're also going to talk about how much should you have set aside as a cash reserve. It's a good question. We're also going to talk about, there's no free lunch on Wall Street.

Hello again everybody, welcome to the Mullooly Asset Show, I'm your host, Tom Mullooly. This is episode number two. We do have lots and lots of videos on our website also lots of podcasts, but we've decided that we're making a clean slate, we're going to start with new episodes, so this is episode number two and we thank you for tuning in. What we talk about on these videos are the answers to the questions that we get from you, from our clients, from people with financial planning questions, with questions about the market and investing, so bring us your questions, come on, let's bring them on. You can reach us through Twitter or through email, but we'd love to have your questions because that's really how people learn. So, Casey, take it away, what's the first question today?

Casey : Hi, the first question is, what happened to the stock market on August 24th, the Dow Jones went down a thousand points?

Mullooly: Okay, so what happened on August 24th? I know this is now a while since it happened, we're filming this in December, so it's been a while but still, the market went down a thousand points one morning, how did that happen? It was August 24th 2015. A lot of people are going to point to different reasons why. The European markets were falling apart, China had been down the night before 7 or 8% ... I think the market was down because it was Casey's birthday-

Casey : Yeah, right.

Mullooly: ... But what happened that day? Why was the market down a thousand points? We had a lot of folks that had thrown in sell orders and a lot of people that had stop orders already listed. I think a lot of people who use or used stop orders didn't truly understand how they work. I have been surprised over the years at how many people in the investment community didn't really understand how stop and stop limit orders actually work. Some of the things that we found for example on August 24th, some of these ETFs that we follow, these exchange traded funds ... Now, they're called exchange traded because that's where they trade. Some of these ETFs were sliced in half the morning of August 24th. While the Dow was falling a thousand points, these ETFs were really getting hit a lot more. Before I talk about the ETFs, I want to just point out to you, a thousand points sure sounds like a lot, but back in August the Dow was trading between 17,000 and 18,000, so we're talking about a 5 or 6% decline. Nothing like we saw in 1987, but still, a thousand points gets everyone's attention.

What about these exchange traded funds? There's folks in our line of work who I think don't really understand how exchange traded funds work. Really, an exchange traded fund is nothing more than a basket of stock, there's no secret sauce that's added into it. What you need to understand though is that, that value, the net asset value of the basket is recalculated every 15 seconds while the markets open. So if a stock or two in the basket start moving up or start moving down, you're going to see the change ripple right through the exchange traded fund where it's invested. So, what happened that morning?

Imagine you are invested in an ETF that owns a hundred stocks. That morning, only half of the stocks on the New York Stock Exchange opened for trading at 9:30 when the market usually opens. Picture this basket where they're trying to calculate the value, 50% of them are actually trading with live prices, the other 50 are closed, they're not open, but yet we have people who own these ETFs hitting the sell button at home or in their broker's office trying to sell these things at the market. They can only go on what the value is at the time, so if you have stocks in your ETF that are not open yet for trading, there is no price. That's why the value of these ETFs dropped a lot in the early minutes of trading on August 24th 2015.

There's another problem, not only did you have people just hitting the sell order saying get me out at whatever price, we also had people who made use of stop orders. The best way to explain a stop order is, if you have an exchange traded fund, say it's trading at $44, you want to have a 10% trailing stop, you put in a stop at 40, 10% below. That doesn't guarantee that you're going to get out at $40. All the stop order does is it says, hey, if it ticks down to $40 this now becomes a market order. That's the problem, because on the morning of August 24th, your stop got activated at 40 but your trade didn't get off, it didn't get sold until maybe $30, $28, who knows where the bottom was on that day.

You have to be super-careful about using stops and stop limits. In fact now the New York Stock Exchange is openly talking about not using stops anymore, that's probably a good idea. We don't use stops, we use [charts 00:06:35] so we know exactly where our entry and exit points are and we know that going into our positions. That's why we really don't want to get wrapped up using stops. I think a lot of people were using them but didn't truly understand what was happening, they all learned a lesson on August 24th. What a way to celebrate Casey's birthday, huh? All right Casey, what have you got for us next?

Casey : Next question we got is, how much do you recommend having as a cash reserve?

Mullooly: Okay, we get this question asked a lot and it's great topic for conversation. How much should you have as a cash reserve before you start to invest? There are some people out there who say, well, I'm not earning anything at the bank, so whatever I have, I'm going to throw into a mutual fund or I'm going to throw into some investment. First of all, you're putting your money at risk, so understand that that's not some kind of guaranteed way to make money. One of the other things that you probably found out too is that once you have money in the bank, before you start to invest, once you have money in the bank, it changes your perception about the value of things. If you're not living paycheck-to-paycheck and you have a little bit of reserve behind you, you are going to find that you're going to be questioning, hey, do I want to spend money on that? Do I want to really put that money into something like this? So having a little bit of a cash reserve really does help clear up what kind of decisions that you make.

Now, how much of a cash reserve should you have? It's always a good idea to have several months of expenses. A couple of months of your mortgage payments, your insurance payments, putting food on the table. We're not talking about taking that big trip to Puerto Rico or something like that, we're talking about having that number that's going to make you sleep at night and feel comfortable. That's a number when when we sit down with our clients, that's the number that should always be under the investment account, that should be at the bank. So, how much should you have as a cash reserve? It's really an answer for you, you should have something, don't use the stock market as your cash reserve. Casey, what's up next?

Casey : I got a call from a planner telling me that some investment they suggested had no fees, how can that be?

Mullooly: Okay, I have to tell you that there is no free lunch on Wall Street, I hope you understand that. People don't work for free in this business no matter what they say, that there's no fee attached to it. There's always some kind of cost attached to it. Please understand that before you get mixed up in an investment. I would be a little skeptical if someone says there's no fee. This particular question came from a client who said a relative of his got a call from a financial planner, they were going to sit down with him in the next couple of days where they were actually going to be paying a fee upfront and then no fees at all for the duration of the investment. Hard to tell exactly what that meant because we don't have a prospectus, we don't have more details. We need more information on that, but understand that people don't work for free, there is no free lunch when it comes to investing or Wall Street.

It doesn't always have to be the most expensive way to do it, but there is always some kind of cost involved. If you've got questions, talk to a financial planner, talk to an adviser, call us or get in touch with us on Twitter or any way that you can. We will be happy to answer questions that you have without any kind of cost or obligation. Okay, that's all we've got for episode number three, thanks for watching. Don't forget, if you're watching this on You Tube, hit that red subscribe button right down here. Otherwise, if you've got questions, find us on Twitter, find us on other social media or email, but ask us your questions. We'll talk to you soon, we'll see you in episode three.