Speaker 1: In this episode we're going to talk about The Big Short, we're going to talk about what's a FASB, mark to the market, and why we don't rely just on fundamentals.

Welcome to the Mullooly Asset Show. I'm your host, Tom Mullooly. This is episode 2 handfuls. Episode 10, the Terry Collins episode. Just also a hat tip to our friend Mike Piazza, congratulations on getting into the hall of fame.

A little word to Mr. Alderson, if you're tuning in, just sign Cespedes, will you? Let's get this over with. We want to win the pennant in January.

When we answer these questions that we cover in these videos, there are topics that we're talking about with our clients or talking about with other people, so we know that these topics are on your mind, so if you've got a question that you've been thinking about asking your advisor or asking us, get in touch with us. We're probably going to feature it on a future video.

What we do in these videos, Casey asks the big questions and then I'll try and break it down into simple terms that everybody can understand, so Casey, let's roll, big guy.

Speaker 2: In another video you talked about the movie The Big Short. Was it just the banks that caused all this?

Speaker 1: Was it just the banks? I don't think so. The movie The Big Short, everybody's seeing this now. There's a lot of people asking me if I've seen the movie yet, so if you haven't seen it yet, buy a ticket online and go see it. If you do have the time and you're a book reader, I strongly encourage you to read the book. It goes into a lot more detail than a 90 minute movie. It's a really good topic. A lot of people are talking about this, and it wasn't just the banks. In fact there was some accounting changes, of all things, that really kind of was one of the triggers to set this whole collapse in motion.

In 2006 the Financial Accounting Standards Board, FASB, announced that they were enforcing mark to market accounting for banks and investment companies. What that means is prior to using mark to market, if you're a bank or a mortgage company and you have a loan on your books or a bond on your books, and say it's worth a hundred thousand dollars or a million dollars, that would be carried on your books at face value. It would never change up and down. Now banks and mortgage companies, people in the lending business, they lever up against these assets in the account. What the mark to market accounting practice now says is, hey, every day you need to change this and reflect the value of these based on today's prices.

That works in commodity markets. In fact mark to market really began at the Chicago mercantile exchange. In fact if you've ever seen trading places at the end of the trading day when everybody's going crazy and the guys that run the exchange come up to Randolph and Mortimer and they're like, "Okay, margin call, 370 million dollars," or whatever the number was, that actually happens on the commodity exchanges. In some cases it's not just once a day, it's twice a day. Mark to the market is something that they really wanted the banks and the wall street firms and mortgage companies to accurately reflect the value of the securities on their books.

There's a big problem though. These mortgage backed securities, they don't trade a whole lot. In fact we've gotten in the habit of telling clients that stocks trade on an exchange but bonds trade by appointment. You really don't have the liquidity that you would have for each single specific bond offering. It was kind of tough for these mortgage companies to start accurately reflecting what they were. The bigger problem behind that was people were crapping out on their mortgages and they wrote some really risky, or bad, loans, and they were not performing, and so the value of these bonds started shrinking and then as the value went down you have a shrinkage in their balance sheet but you also don't have the collateral anymore to loan, so this whole thing just kind of spun out of control. Mark to market and the Financial Accounting Standards Board, FASB, was one of those triggers that kind of helped start this whole collapse.

That actually happened in 2006 and then by 2007 we started seeing mortgage companies fall apart. In 2008 we kind of all know the picture. We've seen the movie, right? The Big Short.

Casey, I want to just keep this going for another moment. While we're talking about Financial Accounting Standards Board, one of the things that they're talking about now is materiality. That's a new word that we're going to need to get used to. The whole idea with materiality as being proposed by FASB is they now want to give the boards of public companies a little more discretion on what they're required to disclose to people.

Just think about this, suppose you're getting ready to release your company's earnings for the quarter and you discover that a client of yours who represents, say, 5 or 6 or 7 percent of your business, your revenues, is going away. Don't you think that that would be a material event that you'd need to disclose? Wouldn't your shareholders want to know that?

These are the kind of things now that boards are going to have a little more leeway on what they need to disclose or have to disclose. Fundamental analysts use these kind of reports to update their reasons behind buying or selling different holdings, so this fundamental analysis and this materiality is really going to have a pretty significant impact.

There was a great article in the New York Times this past weekend by Gretchen Morgenson. She's a great business writer. You may want to take a look at it if you have the time. Materiality. I think that's a word we're going to have to learn to get used to in 2016.

Casey, what else have you got for us today?

Speaker 2: Do you only use charts in your work? Do you consider the fundamentals when deciding what's a good investment?

Speaker 1: Interesting question on a day like today where we're talking about things like the Financial Accounting Standards Board and mark to market accounting. This very morning Ford Motor Company announced that they're changing their accounting for their pension plan and retiree benefits, and they're going away from the accounting method they were using now to mark to market accounting. We were just talking about this.

In this instance, by switching to mark to market accounting, Ford's actually going to show an extra gain for this year, but here's where it gets interesting. Ford is now going back in time and they're going to be restating their earnings for 2011, 12, 13, 14 and 15. 5 years of earnings history they're ripping up and they're rewriting history.

This is why we don't just depend on fundamentals. Our friends at Dorsey Wright have a great saying which we've adopted around here. You can make beautiful music with fundamentals. You can make the chart sing with using technical analysis but if you marry fundamental analysis with technical analysis you can play the piano with both hands and you can really sing a great song. We try to marry the fundamentals with the technicals.

The fundamental picture can change though, and that's exactly what's happening with Ford. Think about it. They've now gone back and rewritten history for the last 5 years. Not even just one quarter. 5 years. The story is changing and every company has the wherewithal to do things like this, so we can't just hang our hat on fundamentals because companies can fudge the numbers. They can go back and say, "We're going to revise our earnings for last year or last quarter or the last 5 years." It's kind of tricky because things like earnings per share, which is a big thing that fundamental guys use, earnings per share, earnings per share growth, the growth rate, [EBIDA 00:09:49] which stands for earnings before interest taxes depreciation amortization, even things like PE numbers, they're going to change when you change the fundamental story. We do look at the fundamentals but we also look at the technicals, because the technicals are telling us what's happening today. What's happening right now? They're not going to predict the future. They're not going to be able to do something like that, but they're going to tell us are there more sellers than buyers?

Remember, it doesn't really matter what the news is about a particular company today. It's what happens. It's how people react to the news that really makes a difference. It's interesting how sometimes good news is good for the market and bad news is bad for the market, but there's also times where bad news is good. Got to figure that one out. That's why we don't just hang our hat on one thing like fundamental analysis. We try and put them both together.

That's all we've got today for the Terry Collins episode 10. Don't forget, Mr. Alderson, Cespedes, that's your job, that's your homework for the next few weeks. Get him in there before spring training starts. That's all we've got for you. Remember, if you've got a question you're probably not the only one that's thinking about it. Get in touch with us. We'll be happy to answer your questions in an upcoming video. If you're watching this on Youtube don't forget to hit that red button and subscribe. Okay, we'll see you on the next episode, that's number 11. That's the ... Casey, who are number 11?

Tahata. Wayne Garrett, he was a great Met in the 60's and 70's. Okay, see you on the next one.