Casey Mullooly: Welcome back to the Mullooly Asset Podcast. This is going to be episode 380 and just me this week, your host Casey Mullooly. I'll be flying solo at least to start and then actually all three of the guys will be joining me. Tom, Tim and Brendan will be joining me, not live, but they will be joining me later on in the podcast. So as most of our listeners know, we try to talk about topics that we find relevant, whether that's in the financial media or our corner of Financial Twitter, or FinTwit but we also like to talk about things people that we work with, our clients are talking about and are coming to us with and asking us questions about.

Casey Mullooly: And one of the more common themes that we've seen over the last couple of weeks has been this narrative around inflation and specifically what that means for your financial plan and what that means for your investments. So there are a couple popular misconceptions or misnomers or just associations that are made that aren't necessarily true about inflation and investing.

Casey Mullooly: The first, most popular misconception about inflation and your investments would be that de-risking your portfolio is the right thing to do if you're concerned about inflation moving forward. We're not saying that this is what we're doing, we're just saying, this is hypothetically, if you believe inflation is going to continue and be significant in the future one of the things that you would think to do is to de-risking your portfolio, whether that means getting out of the market completely, putting all of your money into cash, or adjusting your asset allocation down to something more conservative.

Casey Mullooly: And while that might feel like the safe right thing to do, that is actually the riskiest and worst thing that you can do. I'll say that again, while de-risking your portfolio might feel safe, it is actually the riskiest thing you can do. And why is that? Well, your money today will not be worth the same amount in 10, 20 or 30 years. Things will cost more in the future than they do today. And in order to keep up with that fact is by investing in the companies that are making the things that we are paying for.

Casey Mullooly: One of the reasons why you have to invest in the stock market is because simply just hoarding cash will not keep up with inflation. If you think inflation is going to be rampant in the future, you would actually want to own more of the stocks to act as more of an inflation hedge. Again, we're not saying that this is what we're doing with our plans or our allocations, but we're just trying to address some of the questions that people are coming to us with.

Casey Mullooly: I have some interesting statistics to share from a recent post from Ben Carlson, who blogs over at A Wealth of Common Sense. He actually looked at the individual years what the inflation rate was and what the S&P 500 returned and what he found... This is dating all the way back to 1928. So about 90 years of data here. And what he found is that there is no clear pattern. Interesting, just because inflation is high doesn't necessarily means that investments are going to be bad and just because inflation is low doesn't necessarily mean that investments are going to be good. Those things are not necessarily true.

Casey Mullooly: There were 17 years that he tracked where inflation was the highest in the United States. There were mostly in the 1940s and around the 1970s, eight out of those 17 years, the S&P 500 was up double digits. Nearly one third of the times, returns in the S&P 500 were more than 20%. And the average return for the S&P 500 in these 17 years when inflation was the highest was actually 9.4%, which is basically the long term average over the last 90 years.

Casey Mullooly: So what Ben's point is saying is inflation doesn't necessarily mean anything at all for your investments. If anything, it's pretty normal in terms of the dispersion of returns. It's always good to put numbers behind these sorts of things and to deal in numbers and not in narratives.

Casey Mullooly: One of the other popular misconceptions that we often hear when inflation fears are peaking is gold and how we should be buying physical gold, because dollars won't be worth anything in the future. And I just wanted to share some numbers around that quickly, gold is supposed to do well when inflation is running hot. Yet today in 2021, when inflation has been so bad, "So bad." Gold is down 6% and hasn't made any money since 2011. So in the last 10 years, gold has been flat. We've had these conversations before, "There's nothing really new in the stock market, there's no real news stories." You always hear that and it's kind of true.

Casey Mullooly: So we actually had a conversation about gold and how it's not a good inflation hedge. We had this conversation about a year and a half ago, all the way back in May of 2020, when some of the first crazy economic data points were coming out from the pandemic. We talk about how gold is an uncorrelated asset, not a negatively correlated asset and how that's not what you want when you're building an investment portfolio. So here's a clip of that conversation from May of 2020.

Tim Mullooly : The article also then went on to move from long bonds to gold, and I feel like the same thing is true for what we just said about long bonds, the same thing is true with gold only just amplified to an even more violent stage because gold just swings up and down on an even more violent path than long-term bonds would.

Tom Mullooly : I'm smiling cause I know that Brendan is about to give his investment thesis behind gold.

Brendan Mullooly : I just think that if you're going to look at long-term bonds like insurance, which I think John wrote in the article and I think makes a lot of sense. So you're going to have a cost... In years where the market is up you're going to have a cost your insurance premium because you had these bonds in your portfolio and you didn't need it because you didn't have a car wreck. But if you're going to infuse gold into that to be a diversifier, you talk about things like golds... Gold and just all alternatives in general, you hear this for things like managed futures and a lot of alternative investment strategies, they're uncorrelated.

Brendan Mullooly : That doesn't mean that they're negatively correlated. So meaning, instead of having an insurance policy, so treasury bonds... And this doesn't always work perfectly for them either. Sometimes they go down in tandem with the market, but they're probably the best thing out there we've got in terms of offsetting market losses. So with that you have just a pure insurance policy, meaning you crash your car, the stock market's down, your bonds are going to offset you to some degree based on how much insurance you bought, how much your money had in bonds.

Tom Mullooly : It's the airbag.

Brendan Mullooly : Right. But if you do that with gold, gold is just random. So you could drive around and have... It's a nice sunshiny day and you just go for a drive and they're like, “Here, here's the payout.” And you're like, “What's this for? I didn't crash my car.” And gold’s like, “Hey, just take this money, it's fine.” And then you crash your car. And gold is nowhere to be found. Nothing to offset your losses whatsoever because gold is random. It's not there for you when the market goes down, it might be down more than the market. But, considered in the context of an overall portfolio like a lot of alternative strategies are, you can look at it and say, “Hey, you got a similar return and the volatility wasn’t as bad and so you should have five or 10 or whatever percent in this thing.”

Brendan Mullooly : Again, I just think the behavioral risk, you're like, “Hey, bonds and stocks did this. What the heck is gold doing? Why is it doing that?” And if it’s not there to help you when you need it in terms of offsetting risk, I’m not sure most people can hang with an asset class like that in their portfolio. So if your thesis is just like, “Gold went up the last couple of months, let’s put money into it.”

Tim Mullooly : We talk about how hard it is to time the market with stocks, trying to time gold, good luck.

Brendan Mullooly : If you like GLD today at the price that it’s at, you could have bought it at this price in 2011-

Tim Mullooly : Almost 10 years.

Brendan Mullooly : And you would have been underwater the entire time from then until now.

Tim Mullooly : Yeah.

Brendan Mullooly : So I don’t know about moving forward into the future, I just know that in the past gold has been totally random and to bake that in as a big component of your portfolio, I don’t know what you should expect from that. It might help move them forward, it might not. It might be a diversifier, it might not. I don’t know.

Tom Mullooly : We don’t know. One of the arguments that I heard recently was, “Hey, the fed printed...” I’m using air quotes, “Printed money coming out of 2008,” with all this quantitative easing and now they're doing even more printing. We got to have inflation with that. So don’t you think that gold will do well? I don’t necessarily believe that.

Brendan Mullooly : We had an episode of the podcast within the last year where we talked about gold as an inflation hedge, and I have numbers because I remember talking about this. So since 1975 when it became legal to own gold again on a real basis, meaning adjusted for inflation, gold has returned 0.8% a year annualized. Stocks have returned 8.3% a year annualized on a real basis over that time period meaning that should be the primary inflation hedge in your portfolio just stocks. And bonds... So again, maybe not the best predictor of future returns, but over this time period from 75 through-

Tom Mullooly : That's 45 years.

Brendan Mullooly : Last year, you got 5% a year real return on your bonds. Now again, with yields where they are today, I'm not sure you're going to get a real return on your bonds, but I think you probably still want to own them as an insurance for your portfolio anyway if you're at such a stage where you can't afford the volatility because you're living off your money or close to it. But even if there's no real return, if gold is supposed to be the inflation hedge, I'm not sure I see historical precedent for that. You could look during pockets of that time where it was, then you could see other times where it wasn't. So I'm not sure you could bank on that in the future if there even is inflation because we heard the same boogeyman stories about inflation coming out of the financial crisis-

Tim Mullooly : Right and did that happened?

Tom Mullooly : No.

Brendan Mullooly : The inflation never came.

Tom Mullooly : Yeah. I thought the way that it was phrased in the article made a lot of sense. Good news about gold, the returns were uncorrelated with the equities. They're going to do their own thing. And he said the bad news about gold is the correlation was not negative.

Brendan Mullooly : Right there you go, which is-

Tom Mullooly : So it means that, if your stock portfolio has a car crash and you own gold, you could actually have a car crash and crash into your house. It could be even worse.

Brendan Mullooly : Yeah. The gold could be down too.

Tom Mullooly : Yeah.

Brendan Mullooly : And again like we said, no guarantees for bonds being the perfect seesaw relationship with stocks either. But if we're using history as any kind of a guide, and if we're not doing that, I don't know what we're supposed to do, then I think treasuries remain the best ballast to the portfolio in terms of set offsetting stock risk.

Tom Mullooly : All right, before we move on to our next topic, please give us the Warren Buffett definition of gold as an investment.

Brendan Mullooly : Oh, is he the one who calls it a pet rock or was that Jason Zweig? I can't remember.

Tom Mullooly : I thought it was Buffett.

Brendan Mullooly : Yeah, I think they go hand in hand. Zweig edited the intelligent investor of Graham. So a lot of their stuff gets intertwined in my head, but there's no return stream, we can project from a business or from a bond from the government or a company. There’s nothing to project with gold. It’s just a rock that you find in the ground and you have to sell it to somebody later for more than you paid for it today. And to predict what people’s feelings are going to be about gold in the future, I don’t really know.

Casey Mullooly: So yeah. Gold, not a great inflation hedge historically, it worked once doesn't necessarily mean that it's going to work again in the future. But like I said, that's another popular suggestion that we hear all the time from people. If inflation is running hot, then you should own gold and that is not necessarily true. So I wanted to jump forward... Well, jump forward from May, but back from where we are now, which is late October, so wanted to move to another conversation that we had back in August of 2021.

Casey Mullooly: We were talking about TIPS. TIPS are Treasury Inflation-Protected Securities and some of these funds were raking in a lot of inflows this year, meaning that a lot of people were moving money into this area of the market because they were concerned about inflation. We talked about another typical suggestion that we hear, which is if you're concerned about inflation, then you should be getting into things like structured notes or fixed annuities.

Casey Mullooly: The idea behind this is you want with these products is that they pitch you on locking in a certain rate and if it sounds too good to be true, that's because it usually is. We break down why these things if you're locking in a fixed rate, how at isn't a great inflation hedge either. And we hit on why, again, stocks are the best inflation hedge out there. So we're just going to jump right into that conversation from August of this year.

Brendan Mullooly : Bonds are not the inflation hedge of your portfolio. We like when things fulfill the role and it would be great to have a piece of the portfolio that did it all, but that’s not how it works. So stocks are there to hedge against inflation and to make sure you get the growth you need for your plan to work, bonds are there to preserve principal and make sure that the account’s not so volatile that you can’t handle it and to fund cash flows that are coming up in the next few years. And that’s why they're married together, like peanut butter and jelly. They’re just great components of the portfolio there. I think it’s worth keeping that in mind, because obviously if we could have something that did both of those, that’d be perfect and we would invest in that all the time but short of that, you need to pair things up appropriately.

Tom Mullooly : You mean like structured notes.

Brendan Mullooly : Oh, Jesus. Yeah. It reminds me of how we talk about variable annuities in many cases. It’s like, "Okay, you have insurance and you have investments and they can both serve a role for a financial plan. People need to insure risks that they're not capable of otherwise bearing on their own." Great buy insurance for that. Investments are investments. You invest for a reason. So do that and do not combine those two things. And so yeah, when you try to combine inflation hedge and safety, I think you get the worst of both worlds, meaning like high fees and complexity and just garbage.

Casey Mullooly: Yeah, very well said.

Tom Mullooly : I think when we're talking about... Again, I don't want to hijack the idea behind the podcast, but when we're talking about things like annuities and structured notes and crazy stuff like that, if they were that great, why are they offering it to you?

Brendan Mullooly : And why are they paying somebody 5% to sell it to you?

Tom Mullooly : In some cases 9% to sell it to you. I was just about to ask the both of you, who do you think is buying these funds? [Crosstalk 00:16:50]. Are these folks that are buying these investments, are they just people on their own who are finding this and thought they've discovered a pot of gold? Or are these financial advisors who are luring people into this kind of stuff? No, I'm not saying that these things are bad. They're not but-

Casey Mullooly : They have a role.

Tom Mullooly : But they're misleading in terms of when they cite yields that are six, seven, 8%. That's just wrong.

Brendan Mullooly : I'm sure there are some people buying it because of that. I think for the most part people are buying TIPS because they think inflation's going to be high and they want to preserve their-

Casey Mullooly: It's a narrative.

Brendan Mullooly : Their principle. It's anybody's guess as to whether that will play out well for them or not, but I know how it's turned out for the last 30 plus years for people who have done that. So maybe it'll be different this time.

Tom Mullooly : I think people in general tend to lose their minds when we start talking about inflation because it's invisible. They can't see it. The only place that they do see it is at the grocery store or at the gas pump or when they're trying to buy a house and they see this-

Casey Mullooly: Or a used car.

Tom Mullooly : So see this price appreciation for no good reason but the point that we try to drive home with people is if you are investing in companies, companies that can... They've got to pay their employees more money, of course, but they can also raise their prices to keep up with the cost of their materials and still maintain a healthy profit margin that may be the single best hedge against inflation that you could find.

Brendan Mullooly : Agreed.

Tom Mullooly : But I think people forget that they're like, we got to have crypto. We got to have gold.

Brendan Mullooly : Stocks.

Tom Mullooly : Yeah.

Brendan Mullooly : Stocks are a way to go.

Casey Mullooly: So with all of these things in mind with how de-risking is not the right thing to do, dispelling the gold myth, and then touching on some of the fixed product environment, these are things that we're paying attention to and that we're hearing frequently, whether it's from people in the media or from our clients. So like I said at the very beginning, we want to let you know what our thoughts are on these subjects. And that's what the whole goal of these podcast videos and blog posts are, is to share our thoughts on these subjects with you, our listeners. So that's going to do it for episode 380 of the Mullooly Asset Podcast. Thanks so much for listening. And if you have any questions, please feel free to get in touch with us.