Casey Mullooly:
Hello and welcome to the Mullooly Asset Podcast. This is your fill-in cohost, Casey Mullooly. I'm joined here by Tom Mullooly and Brendan Mullooly. I'm not going to offer any fun facts or zip codes this week, because I botched last weeks. So, I'm taking this week off. This is episode 359, and we're just going to jump right into it.

Casey Mullooly:
We have a couple articles from the Wall Street Journal this week, three articles to be exact. The first one we're going to talk about which I know we also did a recent video on something similar, is about portfolio rebalancing and how it is a good retirement habit. The video we talked about was about some of the indices that are going through their annual rebalance. We talked about the Russell 2000, but the Russell 1000 and the Russell 3000 are also about to go through their annual rebalance in a couple of weeks here.

Casey Mullooly:
So, as a general strategy, rebalancing is taking money from the winners of the portfolio and reallocating them to the losers of the portfolio. So, what is the idea behind that and why is that a good strategy for investing?

Brendan Mullooly:
I think it's important to clarify when we talk about rebalancing, that we're talking broadly in the sense of asset classes or even within asset classes, equities like stocks, like small caps versus large caps and not individual stocks like, "Hey, I own Apple and I'm taking money from Apple to buy GE."

Brendan Mullooly:
Because I'm not sure that that is a sensible strategy, taking money from winning individual names to throw into losing individual names because the variance is so great and we don't know necessarily where things are going over the longterm. But when we're talking about things like stocks and bonds at a high level, I think it's unfair to even consider bonds a losing investment in a good market environment because you didn't own them in the first place to keep up with the stocks.

Brendan Mullooly:
So, really what you're doing there is making sure that your portfolio doesn't become riskier or less risky than you intended it to be when you set out on the course of creating it in the first place.

Tom Mullooly:
I think in the article, they referred to a Vanguard mix of funds that showed if you were 60/40 in global funds at Vanguard five years ago, and did not rebalance that portfolio that was 60/40 five years ago is now 72% in stocks and 28% in bonds and cash. And that's a good example of how these allocations can drift if you take your eye off the ball.

Casey Mullooly:
So why is that a bad thing?

Tom Mullooly:
We usually get to answer that question around the time when the market's falling apart. And so year ago in the spring, in March and April, we had clients who said, "Gee, I've seen the stock side of the portfolio go down, the bond side has gone up. Gee, I wish we had more in bonds at the time." Well, if the proper rebalancing had been going on all along, you probably would have been close to that allocation. And I would say Brendan, maybe you'll agree... That over the last year where we've seen the market do pretty well, that some of these allocations are starting to get near the edge of the bands. Would you agree?

Brendan Mullooly:
Yeah. I think the question of why would you bother rebalancing, is such a bull market question.

Tom Mullooly:
Oh.

Brendan Mullooly:
Because I think that over the longterm, if we're talking about the split between stocks and bonds, you will likely do better over the long-term by not rebalancing. Because we expect that bonds will be a drag on performance over the long-term. But if we're not only concerned about performance, but also volatility and getting to the longterm by surviving the short terms along the way-

Tom Mullooly:
And having money.

Brendan Mullooly:
Right. Especially yeah, especially for people spending from their portfolios or close to even doing that, the idea of rebalancing makes a ton of sense just because it's risk management.

Brendan Mullooly:
We want to make sure that if we didn't intend to be 100% in stocks that we remain at whatever level was comfortable and was a fit for the plan beforehand, so yeah. And the way that we handle that to bring things back to where you left us there, was you set out with a portfolio and you want to make sure that it's staying close to that. Some people like to say, "Hey, we're going to rebalance same month every year or the same two months every year and set it that way." We prefer to just make sure the portfolio is remaining close to its targets. We don't want to be overly sensitive, but we certainly want to take action when it's drifted significantly enough to move the needle for us, so to speak.

Brendan Mullooly:
And I think the article said the idea that you just need to have an approach to that versus nitpicking which one might be better than the other, or the next.

Casey Mullooly:
The article mentions that studies have shown only small differences in returns from rebalancing monthly versus quarterly or annually or over as many as four years. So like you said, it doesn't really matter when

you do it, you just kind of have to have a system in place.

Tom Mullooly:
And I think the system is also, I'm using air quotes, "Client-driven." A lot of times we'll go in and rebalance or change the allocation in a client's accounts because they've told us that their situation is changing. And so, okay, we need to get more aggressive or we need to get more conservative because you're going to be using cash as an example. You're going to be making some withdrawals. And so while we're constantly monitoring what your exposure is, what your allocation is, sometimes the allocations come just because the client's called up and said, "Hey, I need to start taking money out of this account."

Casey Mullooly:
Yeah, I know we've also gotten calls in the middle of a market downturn, like we saw last year in March and April, and all of the sudden they want to get more defensive. They want to go just using ballpark numbers, let's say they're 80/20 and they call in and then they want to go 60/40 or 50/50. So, why is that a bad time to be doing that?

Tom Mullooly:
Well, if you think about rebalancing, it's inherently countercyclical, which I think is to its benefit over time. You're being somewhat contrarian and saying, "Hey, things have been good. We're going to sell some stocks and buy some bonds." Or vice versa. "Things have been bad. We're going to buy some stocks and sell some bonds." What you're talking about is being pro cyclical, and assuming that what's happening today will happen in perpetuity in the future and that's why we need to take action on it now. I think that being pro cyclical, while it may feel good and even be right in the short-term, is likely to look pretty stupid when you stretch it even as far as a couple of months or years out. I think you'll be kicking yourself over that sort of a decision.

Casey Mullooly:
All right so you'd be selling stocks when they're already down and going into bonds-

Tom Mullooly:
When they're already up.

Casey Mullooly:
When they're already up which is the opposite of what rebalancing is meant to be?

Tom Mullooly:
That's right.

Casey Mullooly:
Which is usually the opposite?

Tom Mullooly:
Yes. So, we talked about rebalancing between stocks and bonds, but I'm thinking of even within an asset

class too, within stocks, you can rebalance the portfolio, in the sense that, example that comes to mind is last year, some of the things that we had been rebalancing back into over multiple years that had been laggards in the portfolio came through in a big way in the second half of last year, and the first half of this year now. In the sense of small and mid cap companies, value stocks and international stocks.

Tom Mullooly:
All of these things that we had rebalanced back into that had lagged behind things like large cap growth and momentum and technology. Yeah, it felt painful probably over the years to continue adding to these things that had lagged behind. Then lo and behold, they shoot ahead suddenly, without warning, and fortunately we had been adding and rebalancing to those along the way while their prices were down. And so think rebalancing within an asset class too is valuable because-

Brendan Mullooly:
We just don't know when these things are going to start to move.

Tom Mullooly:
We don't know. Yeah, we don't, but we know that they all have positive expected returns. We expect them all to do what we need them to over the longterm, but they're going to take different paths to get there. So keeping the faith in all of them and, and adding to all of them when they've gone through tough stretches is probably better than doing the opposite, like what you just alluded to the opposite of that would be only adding to them after they've done well. And when you put it that way, I think it hits home for a lot of people why you would want to do the reverse.

Brendan Mullooly:
So last year in July, August, into September, we got a few inquiries, why do we still own small cap stocks? The other investments that we have are doing much, much better, why do we still own these dogs? And lo and behold, small caps had a good year in the fourth quarter last year. And that continued into this year, but the thing is, they produced a year of returns inside of three months. We just don't know when this is going to happen.

Tom Mullooly:
If you strip that month, few months stretch out of their annualized, one, three, five-year numbers. I bet they would look like total crap.

Brendan Mullooly:
Yeah.

Tom Mullooly:
If you missed them and then try to pile on after like, "Oops, I missed it. Let's add them back to the portfolio." Too late.

Casey Mullooly:
Yeah. It doesn't work like that. I think me and Tim joke about something similar like that when we're playing golf. Where it's like, "Well if I didn't have that three putt and that ball out of bounds and I didn't

get a 10 on that hole, then my score would be pretty good."

Tom Mullooly:
Yeah.

Casey Mullooly:
It doesn't work like that.

Tom Mullooly:
No.

Casey Mullooly:
All right, we're going to kind of shift gears here a little bit and talk about a tax exemption for home sellers that is, the article says that it could be on the chopping block and the Biden administration's proposed changes to the tax laws would take a large bite from some sellers with the biggest gains.

Brendan Mullooly:
Maybe I get hung up on the language, as you guys know, I'm pretty dismissive of what the media writes. But under that headline in the Wall Street Journal, they had this, "The tax exemption allows millions of Americans to skip taxes when they sell their homes at a profit". They're not skipping anything, they're entitled to that tax break.

Casey Mullooly:
Isn't a tax break designed as an incentive to get people could do something?

Tom Mullooly:
Yeah. So just as an overarching narrative, this may be a negotiating point over the next several months as they hash out potential tax law changes. But I'd bet against changes that take away incentives for people to own homes in this country, because that is one of the most incentivized, through taxes, one of the most incentivized things that we have in this country. There are so many laws that are designed in the tax code to push people towards home ownership. And we can debate some other time whether that's actually a good thing or not, but so the idea that they would pull this sort of incentive back, I think they're going to be hit with lobbyists from many different angles who would be opposed to this, not even considering just individuals and households who would not find this, it would be popular amongst most homeowners.

Brendan Mullooly:
The one line in the article that was most surprising to me was that this $250,000 exemption for single filers and 500,000 for married couples was set in place 24 years ago and has not been budged at all. That number has been set in stone now for almost a quarter century. And think about what homes were worth in 1997 when this was put in place versus today. Today I think is really an exceptional market, exceptional meaning I don't think we'll see this again in the future for a long time, at least. But homes are selling here in New Jersey very quickly, often at ask price or well over ask price with multiple offers coming in. And so this is a real concern because people's gains in their homes are starting to bump up

against these thresholds that haven't been indexed for inflation, that haven't been raised in almost a quarter of a century, and that's a long time to go.

Casey Mullooly:
That speaks to me that it hasn't been changed in 24 years because how many tax law changes have we seen in the last, in the last 25 years? It's every two to three, four years now.

Brendan Mullooly:
Yeah.

Casey Mullooly:
This is staying this way for a reason.

Brendan Mullooly:
So just to clarify, the exemption that we're referring to is on the sale of a home. So-

Tom Mullooly:
Primary residence.

Casey Mullooly:
Primary residence, good clarification.

Tom Mullooly:
Yeah, there was some good stuff in the article about people who want to play games with their vacation home and trying to meet the qualifications. And I would take a pass on anything more than the article in terms of information provides is what I would be able to provide to a person because you got to speak to whoever's signing off on your tax return if you're trying to play those games, I wouldn't advise it.

Brendan Mullooly:
Yeah. At a high level, it's up to $250,000 of profit from the sale of the home for single filers and 500,000 for married filers. So let's say you buy your home for $300,000. You're selling it down the road and you sell it for $850,000.

Tom Mullooly:
So your gain in that example would be $550,000.

Brendan Mullooly:
Right. But only 50,000 of that would be subject to capital gains tax.

Tom Mullooly:
That's right.

Brendan Mullooly:
Which rates right now would put that at about 15 to 20%.

Tom Mullooly:
Depending on the rest of your income. It's going to be a long-term capital gain. So, right.

Brendan Mullooly:
But those rates could go up under the new Biden proposals. The highest rate, the headline rate is over 40%, but that only applies to people with an adjusted, gross income of over a million dollars.

Tom Mullooly:
It's not even clear if it's adjusted gross income, annual income or everything. So some people are very nervous.

Brendan Mullooly:
Yeah.

Tom Mullooly:
Because the sale of the house, may be the biggest asset they've ever owned, that could thrust them into an eye-popping tax bracket.

Brendan Mullooly:
Yeah. So the article mentions that in the first quarter of 2021, the median gain for US home sellers was just over $70,000.

Tom Mullooly:
Right.

Brendan Mullooly:
So we're not even bumping up onto the threshold of this exemption,

Tom Mullooly:
But that's the median.

Brendan Mullooly:
Right.

Tom Mullooly:
So it's not even the average, it's the mid point.

Brendan Mullooly:
Right.

Tom Mullooly:
Right, your mileage may vary. But in terms of who this impacts, obviously home prices in some parts of the country are a lot higher than others. So maybe around here, the median number would be different.

Like if state-by-state, you can take a look at the median.

Brendan Mullooly:
Sure. It would probably be different here, but I still don't know how many people would, even in New Jersey be really subject to this, I would imagine the median for New Jersey, if we had those numbers would still be below the thresholds for both individuals and married couples.

Tom Mullooly:
And it's something that you can, it's not a one-time exclusion either.

Casey Mullooly:
Right, you can do it again.

Tom Mullooly:
It's something that you do together. You can use it again in a couple of years down the road.

Brendan Mullooly:
Two years later.

Tom Mullooly:
Right.

Casey Mullooly:
You can buy another house and move into it and live there for two years. And then you sell that one. Yeah. You just need to meet the requirements. I've heard, and I've seen more people trying to get ahead of these changes to the tax laws. So if someone were to come in and want to do something like that, which direction would you steer them in?

Brendan Mullooly:
Man, if you're, if you're talking about selling your primary residence and the most top of mind thing for you is getting ahead of proposed tax law changes I think you're clinically insane because this is going to be something we talk about every two or four years as power changes control in Washington. So I don't see a reason for that to be your guiding-

Casey Mullooly:
Guiding light?

Brendan Mullooly:
Yeah, guiding light, and the-

Casey Mullooly:
North star.

Brendan Mullooly:

Right. So you're going to sell the home that you've lived in for at least two years, and potentially longer than that, because of this, there's got to be some other stuff on the table for this to be a worthwhile discussion.

Casey Mullooly:
Good point.

Tom Mullooly:
I'll default to the typical discussion we have when we're talking about buying a home for people, when you found the dream home, it's going to be your primary residence going forward. Did you really care what the interest rate was on your mortgage?

Casey Mullooly:
No.

Tom Mullooly:
No. It's doesn't matter.

Casey Mullooly:
You're looking at the hardwood floors.

Tom Mullooly:
Exactly.

Casey Mullooly:
Looking at the view.

Tom Mullooly:
So yeah, if you're driving your decision based on taxes, a tax proposal, it may not may or may not go through. Yeah, we need to get our priorities back in focus.

Brendan Mullooly:
Yeah, definitely. It's something, you want to be aware these changes, but listen, if you're selling your primary residence, I think this is down the list of considerations and I think that for most people, a thing they brought up in the article too is that it doesn't just need to be your sale price less your purchase price.

Tom Mullooly:
Right.

Brendan Mullooly:
If you've accounted for, I guess, so repairs do not count, but improvements do.

Tom Mullooly:

Right.

Brendan Mullooly:
And they even mentioned in the article that replacing your roof is an improvement as opposed to a repair. And so if you've kept track of all the things you've done over the years, which nobody does, because it's more flattering to real estate investing, air quotes, to say, "Oh, I just sold my house for a million dollars. And I bought it for 250,000 back in the day, I made 750 on this thing." Well, I mean, yes, in one sense, but in the other, how much money did you put into repairs and improvements over the years because you used that to adjust your cost basis up, meaning your return is coming down?

Tom Mullooly:
Yeah, are you counting the second floor addition that you put on? It's big.

Brendan Mullooly:
So it's like the discrepancy between when you're having your home appraised versus assessed for taxes, the tax assessment, you want it to be a shed that you live in basically, but for the appraisal, you need it to appraise for the purchase price so that you get your lending from the bank. I would say, this is the same thing in the sense that if you want your gain to look great on paper, then yeah. Say here's the sales price and here's the purchase price and this is what I made on it. But if you're trying to stay under these different exclusion thresholds, you're probably going to be looking for things that you can add into your basis to raise that up. Which lowers your return on paper, but you want the lower return on paper when you're filing your taxes. So we play these games depending on what our goal is, which is just human nature. But-

Tom Mullooly:
Yeah.

Brendan Mullooly:
I get a chuckle out of it.

Casey Mullooly:
A lot of good points in there Brendan. So the last article we wanted to talk about is titled How To Prepare For Student Loans To Resume In September. Since the pandemic started in March 2020, so about the last 15 months or so, folks with federal student loans, haven't had to make payments, that looks like it's going to come to an end on September 30th. So still a couple months away. But the article suggests that people who are going to have to make payments, start thinking about it. If that money was going somewhere else, it's time to figure out how much money you can allocate to student loans while also doing the other things that you've needed to do with that money.

Brendan Mullooly:
For people who have been out of work this has been a godsend. To not have to make payments for the last 12 or 14 months has been terrific. And secondly, this is a great opportunity to hit the reset button and say, all right, I can use the calculators that they mentioned in the article and figure out how much do I actually owe and set a goal and say, "Hey, I want these loans done in four years, six years, eight

years," whatever the number is. But you can get ahead of this now, instead of saying, "I've this bottomless pit of money. I never know when I'm going to be done." I think one opportunity that we have coming out of this pandemic is it's a great opportunity financially to hit the reset button, and whether it's student loans or mortgages or any other kind of plan that you have, whether it's a savings plan or a debt repayment plan, it's a good opportunity now to be looking to figure out how to move forward with this.

Tom Mullooly:
Yeah, I would definitely play with the numbers to juxtapose plans, like if you said concretely, "I'd like these to be gone in five years or two years." Or whatever the number is, to play around with the numbers and the interest rate terms that you have to see what those monthly payments would shake out to if you have a goal in mind, in terms of when you'd like to be out of debt or have that put in the rear view mirror. To juxtapose that versus the minimum payments, which the bare bones there is what is going to come back into force later this year. So you're going to have to make your minimum payments as you were before, but you don't have to only go back to the minimum.

Tom Mullooly:
I know that that's an obvious thing, but you can take a look at your cashflow and say, "All right, I can do the minimum and it's going to take this many more years to have it done with, or maybe there's some extra places I could pull from and if I made a payment that was a few hundred dollars more a month, how much interest and time at the end of the loan is that going to save me and how do I feel about that trade off between whatever else I'd be doing with the money?" Yeah.

Casey Mullooly:
Yeah. You also have a couple of months here until September to make some interest free payments. If you make a payment now there's no interest, so you're just paying down the principal. So maybe this is a good time to, like you said, play around with it, see how your month to month cashflow is doing one number. You can always adjust it moving forward. It doesn't have to be one number for the rest of the time.

Tom Mullooly:
I know people's balance sheets in general from just information, I guess, surveys and stuff we've seen over the last six to 12 months now, personal balance sheets across the country seemingly have improved on average. Obviously there are people who are hurting, which is why we have these sort of programs out there. But if your balance sheet is doing really well, and maybe you weren't making the payments on your loan, and we're just adding to a cash cushion because there was some uncertainty in your life about your job or whatever the case is, maybe take a look at that and say, "Hey, if I've got some excess above and beyond what I need to have at the bank to feel comfortable and secure in that emergency fund." Maybe like Cay said, take a lump sum before these things kick back in and start off that re beginning of the loan payments in labor day time period with one lump sum payment that knocks out a good portion of it.

Brendan Mullooly:
I think this would be a good opportunity to revisit the whole idea about refinancing student loans.

Tom Mullooly:
Yeah, it's worth taking a look at. I think the article brought up some notable cons to financing federal student loans into private student loans, being that if you were working towards some sort of forgiveness program, the ones that are out there for, for federal student loans based on different fields that you can work in for periods of time or-

Casey Mullooly:
It's income-based.

Tom Mullooly:
Yeah, income-based repayment plans. If you've been on that sort of attract, then obviously something that you probably want to avoid, you want to stick with your federal loans, even if the interest rates are not good compared to where they are today. Also back of mind for some people is the idea of student loans being forgiven in some capacity by the government. And if you're not doing federal student loans then perhaps you miss out on that, but I do think that you need to weigh your options and consider if you have good credit and can get a lower interest rate that transforms that loan repayment on your balance sheet in a significant way. It might be worthwhile to take that debt and refinance it to a lower rate and tackle things that way.

Casey Mullooly:
The article mentioned that you could also, if you have multiple federal loans, you don't have to refinance them all.

Tom Mullooly:
Right.

Casey Mullooly:
You could just do if one has a higher interest rate and the other ones aren't so bad, you could just refinance that one loan into a private loan.

Tom Mullooly:
Good point, hedge your bets if you're waiting on loan forgiveness or one of these other things.

Casey Mullooly:
Yeah. Well, I think that's going to wrap up episode 359 of The Mullooly Asset Podcasts. Guys, thanks. That was a good one, a lot of good information in there. And we're one away from doing a full 360 spin and we'll see then.

Casey Mullooly:

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