How Leverage Can Get You In Trouble

Tom Mullooly: In episode 77 we're going to talk about one of the biggest killers of investment and investment returns. It's not what you think.

Welcome to the Mullooly Asset show. I'm your host, Tom Mullooly, and this is episode 77. I was going to say 77 Sunset Strip, but that show was before even I was born, so I would say 77 WABC. Anyway, stay tuned for Yankee baseball.

Tim, what are we going to be talking about today?

Tim: My friend's been telling me about this leveraged ETF that he owns. Do you know anything about leveraged investment products?

Tom Mullooly: Okay. So what I will tell you about leverage and leveraged investment products is that they are the biggest source of tears and pain and misery and suffering and losses that you're ever going to come in contact with.

Do yourself a favor. Stay away from margin, stay away from debt, stay away from leverage. All problems stem from debt when we're talking about money and investing.

And I'm not talking about just on a personal level. I'm talking on a world level, economic level. People worry all the time. They reach out to us and they say, "I heard inflation's coming back. I heard interest rates are going up."

Forget it. I am telling you right now, the biggest destructor of wealth in your personal life and in investing, leverage, debt. Just avoid it as much as possible.

Personally, we see here among our clients people who are selling homes to buy bigger homes that honestly they can't afford. We know it. They're taking loans from their retirement account at work.

They're cashing in their kids' college accounts to help bring money to the closing. They ask us to take a little more risk with our investments so they can catch up to help offset the no savings that they're going to have, and then they pull up to a meeting outside in a leased Escalade.

Debt is such a killer. You don't have to live up to those expectations. Live within your means.

Now, I want to talk about on an economic level, or at least a stock market level, what I've seen over my career. In the 1980s when I got started in the business, all of these money center banks needed help, because they had made loans after loans after loans to all of these emerging market countries.

Every one of them defaulted on their debt, really bad. And all of the banks were stuck with these terrible loans.

And then to make matters worse, a year or two later, we had the savings and loan crisis. The savings and loans were lending money to all of these builders to build these huge communities. No one bought the houses. The whole thing was just a scam. It was a fraud.

In the 1990s, in 1994, because of leverage, Orange County, California declared bankruptcy. Incidentally, they just got finished in July, 2017, paying off the last of their bankruptcy notes. That's a long time to get out of jail.

And then in 1998 we had Long Term Capital Management, which imploded. The smartest guys in the room, they needed a bailout from the fed just so they could not totally upset Wall Street.

In the 200s, in 2006 and 2007, again, banks were making loans to anybody who had a pulse, to let them buy a house. People with no income, no way to afford these mortgages, were getting set up in these mini-mansions, and the banks were approving anybody, like I said, who had a pulse.

And then a year later, what happens? Because of all of the margin, all of the leverage that happened, all of these Wall Street firms and banks had to get bailed out.

They even had to change the accounting rules, the mark to market accounting, just to keep the banks alive. So margin, leverage, debt, it is a killer, whether it's on your personal level or with the market.

So the question started out ... Tim, was that like two hours ago when we got the question? So the question was, "What do you know about these leveraged investment products?" I can tell you before we even dig into it, just hearing the name, a "leveraged investment product," forget it. Forget it. It's a bad idea.

We just saw a leveraged investment product. The ticker symbol was XIV, which is VIX backwards. So this was an inverse bet on the futures, on the volatility of the market. Now, the last couple of years, we've had very low volatility in the market, and this XIV thing, it's actually an exchange traded note, ETN, not an ETF, but this XIV went from $11 five or six years ago up to $144.

Yesterday, it went to practically zero, immediately, because it was a bet on low volatility in the market, and everything was leveraged. So understand what we see from our side of the desk.

We have investors calling us, not clients, people calling us asking what do we know about this thing. We tell them, "Do you know that own futures contracts?" "No, I don't. I own an exchange traded note," an ETN, exchange traded note, that invests in futures contracts.

We are finding that the advisors who sold this to them couldn't actually explain it to their clients, like what was going to happen if a certain thing, like if a market starts seeing more volatility, what's going to happen to the investment.

What is going on? Does that sound like Bitcoin to you? It's amazing how this thing went from ... on January 11th it was $144. Yesterday it was down 99%. 99%. Now, here's what makes it even goofier. XIV at most brokerage firms was a marginable security, so you could margin, you could borrow against the value of this futures contract, alright?

So understand something. When we have volatility like we had last Friday, the market was down 660 points, okay? We used to live in a world, when I got started, it was seven day settlements. So if you bought a stock on Monday, you could pay for it the following Monday and then you had a couple of extra days from the New York stock exchange to get your check in on time.

Then we went to a five-day settlement, then we went to a three-day settlement. Okay? Now we're at two-day settlement.

So if you flip out and make a trade or have a margin call on Friday, what day is settlement? Tuesday. You have to turn around and rip up your portfolio immediately. But this is what everybody wanted. They wanted the velocity of money. When you have velocity, you're going to have some risk. More than anything else, avoid debt, avoid leveraged investments, avoid these things, because they can blow up immediately and without any warning.

Thanks for watching episode 77. Look forward to catching you the next time.