Know What You Own - Transcript

Tom Mullooly: In episode 119, we get a reminder to know what you own.

Welcome to The Mullooly Assets Show. I'm your host Tom Mullooly, and this is episode 119. Thanks for tuning in.

Wall Street Journal article written just a couple of days ago, December 9, 2018. I finished reading the article, and I said to myself, "Wow, I don't know if people acted on this article, they would probably get mixed up in an investment that they knew nothing about." And unfortunately, we see that happening all the time. Clients, new clients, come in. They show us statements from other firms. They couldn't even explain what these investments are.

Keep things very simple. Invest in stocks. Invest in bonds. Invest in funds that invest only in stocks and bonds. Keep this stuff super simple. Anything more than that, you're making it really complicated. If you can't explain your investments to a 3rd grader, you're doing something wrong.

So this Wall Street Journal article, one of the quotes that I took away from it was, "Buying opportunity may be shaping up in preferred shares."

I'm not so sure.

The article went on to mention that during the second half of 2018, some of the preferreds that they were looking at, these preferred shares, had dropped between 10-20%, and they cited, as a key reason for the drop in these preferreds, the spike in ten year treasury yields.

The point that I'm getting to is that the ten year yield may not have really any kind of impact on these preferreds. Much of the article takes different points of views from different people that they quoted on where the ten year treasury yield is headed. That's all irrelevant. It's people's opinions. They could change from day to day, and that's what makes up a market. Don't hang your hat on any of that stuff.

One thing that The Wall Street Journal article did get right is that bonds pay interest, and preferreds pay dividends that might wind up being a different rate for you depending on what kind of tax bracket that you fall into. It's important to know when we're talking about preferred shares, a lot of people get sucked in on, "Hey, I really like that company. I'm going to buy their preferred stock, and I'm going to get a yield of 5%," or 6% or whatever the rate is. Don't get hung up on that because the preferreds don't go up and down a lot of times based on what's happening with the company.

They really get swung around primarily by interest rates, by the credit quality of the company that's issuing, and then thirdly by any kind of news that's going on.

So preferreds are kind of different, and you've got to know what's going on behind the scenes. Many preferreds, especially the ones that have been issues in the last 20 years, are what we call "synthetic preferreds".

Let me kind of unwrap all of this for you. What a synthetic preferred is is a company will set up a trust, and the trust itself will issue bonds. These bonds come due in 30, 40, 50 years. These are really long term bonds. The trust then repackages them and carves them up into $25 par preferred shares. So that's why these preferreds are issued at $25 a share. That's really important to understand.

So it would be as if you owned a bond at 100 cents on the dollar. What's happening with interest rates, the bond will move up, the bond will move down, but it won't get too far away from $25 in price. It's kind of the same way with these preferreds. That they're not going to move far too much from where they were originally issued, and they'll go up, and they'll go down. Again, based on the ... what's happening with interest rates. Remember, your investment is tied to a 30, 40, 50 year piece of paper. Not some liquid preferred stock you think you can sell tomorrow. It's based on the credit quality of the issuing company, and then if there is some kind of news you're going to see that could really impact the stock, you could see things really drop.

I remember American Airlines had come out with a preferred in 1997 or 1998. After 9/11 ... it was issued at $25 a share. After 9/11, these things traded at $5. There were some real questions about whether the airline industry was going to make it out of 9/11.

So again, like we said at the beginning, you've got to know what you own. If you can't explain how your investments work to a 3rd grade, you're probably in something you don't understand.

Thanks for watching episode 119. See you on the next one.