MAM 186: Tim & Tom Talk Everything ETF's - Transcript

Tom Mullooly :

Welcome to episode 186. That's episode 1 8 6 of the Mullooly Asset Management podcast. This is Tom Mullooly. I'm here with Tim.

Tim: Hey, everybody.

Tom Mullooly : We want to talk about a topic that's near and dear to our business, exchange traded funds. Before we walked in here to record this, I looked up and went as far back as I could on the mullolly.net website and I saw that I actually wrote about exchange traded funds in January of 2007.

Tim: Wow.

Tom Mullooly : We've owned them longer than that.

Tim: Right.

Tom Mullooly : In fact, when I was a broker, I owned shares of S-P-Y, SPY, the very first exchange traded fund for some family members, and I had to constantly explain to them for the first three or four years what this actually was. I don't consider myself a pioneer, but an early adapter.

Tim: Good way to put it.

Tom Mullooly : Yeah. They have a lot of benefits, and that's what we really want to talk about in episode 186. Tim and I have prepared a couple of questions. We haven't gone over all of them, so we're going to have a free wheeling discussion about exchange traded funds. Tim, I'm just going to throw this one out. We can answer each other's questions or pitch on things that we may want to add for reinforcement, but why do you think advisors, and especially Mullooly Asset, are using exchange traded funds instead of buying individual stocks or mutual funds?

Tim: Well, to start off, addressing why we would buy that instead of stocks, first thing that comes to my mind would be the risk that comes with owning individual stocks. We've seen it all happen before. Names like Enron come to mind where stock out of nowhere just crumbles to the ground. An exchange traded fund being a basket of stocks, you can still give your clients exposure to certain stocks that they might want in their account, but having it all wrapped under one ETF, one ticker symbol, is a good way to dissipate the risk that one single company could potentially blow up someone's portfolio.

Tom Mullooly : That's a good way of putting it. I'll also add to that that sometimes we're going to see sectors move, and sectors are a lot like schools of fish.

Tim: Right.

Tom Mullooly : It used to be, when I was a broker in the '80s, if oil looked good, we would buy Exxon. If technology looked good, we would buy IBM. If a sub-sector like semiconductors looked good, we would buy Intel. In our work with Dorsey Wright, we have been able to build these matricis that show the top performer from top to bottom. If we do it the old way and say, "Well, semiconductors are doing well, so let's buy Intel," and Intel's at the bottom of the matrix, meaning it's the worst performer or near one of the bottom performers in the group, you're just not going to get that move.

We can capture the entire sector now. Instead of going in and trying to cherry pick which stocks are going to do the best, we can buy the whole sector when a sector's going to outperform. One of the things that Tim brings to the meeting every week is this report on technical attributes and score direction. You want to talk a little bit about that?

Tim: Sure.

Tom Mullooly : Not really what we thought we'd talk about when it comes to ETFs, but it does help to paint the picture.

Tim: It kind of ties in. Right. Every week I run this report on Dorsey Wright, and they have their different rankings of scores that they give to each sector. One thing that you would like to see is a score direction being positive, meaning that it's trending upwards or that sector has been performing better than other sectors in the past. I bring it every week. We look at it on a weekly basis. You can see certain groups like bio-tech or healthcare moving up the ranks over the weeks. That tips us off to which sectors are performing better and also which ETFs within those sectors we're going to want to take a look at and potentially buy for clients.

Tom Mullooly : That whole concept with a sector being a school of fish is so important to understand. If you've ever gone to the aquarium or you watch one of these Jacques Cousteau movies on TV, when you see a whole school of fish change direction, what happens? It's not like one fish changes.

Tim: No.

Tom Mullooly : They all go ... They all make a right turn.

Tim: Yeah.

Tom Mullooly : They go.

Tim: It's a pretty drastic move, and you can see it happening.

Tom Mullooly : Right.

Tim: It happens from time to time, but usually the school sticks together. When you see a handful of the fish in the school start to turn, you're going to most likely see the rest of the school go with it.

Tom Mullooly : Right.

Tim: It's something you want to keep your eye out for.

Tom Mullooly : Yeah. Instead of trying to cherry pick the top two or three performers and guessing wrong, we can just buy the sector and we're going to get the move.

Tim: Just increases your odds of being right and being wrong. Because it's risky to try and pick one stock to go up or down.

Tom Mullooly : Right.

Tim: It's easier to pick a group of stocks. You have better odds.

Tom Mullooly : That kind of answers the question about why we would buy ETFs over stocks in some cases. We still buy individual stocks.

Tim: Right.

Tom Mullooly : But why would we buy ETFs instead of a mutual fund?

Tim: There's a number of different reasons. The first thing that pops to my mind is the cost involved in buying them. ETFs are significantly less expensive to buy. There's no real sales charge since they're traded on an exchange. If you buy them through somewhere like TD Ameritrade, you're going to have to pay four bucks for trading commission, but there's no real sales charge baked into an ETF like there is for a mutual fund.

Tom Mullooly : Right. We sat down with a new client recently and we were going through his statements. Every dollar that he was contributing to his retirement plan was being charges 5.75%, five and three quarters percent. Every dollar that guy contributed on a monthly basis went in ...

Tim: That's unbelievable.

Tom Mullooly : Yeah. It winds up being very, very costly to do it that way. Now, not all mutual funds are bad, and not all mutual funds have that kind of cost structure. But the cost to buy funds compared to the cost of buying exchange traded funds is drastically different. I think if you're in the business, of course you know how fees are structured with mutual funds, but the investing public doesn't know this.

Tim: Right.

Tom Mullooly : It's not their job to know it either. Our job, since we've go a fiduciary obligation, is to make sure that we're trying to keep our clients' costs as low as possible.

Tim: Right.

Tom Mullooly : Exchange traded funds make an awful lot of sense when you're comparing mutual funds versus ETFs. Maybe what we ought to do is just touch on some of the major differences in terms of structure and appearance between ETFs and mutual funds.

Tim: One of the big differences between a mutual fund and ETF, mutual funds, you're going to get intraday pricing.

Tom Mullooly : That's so important. I don't think anybody even gets that, even people in our business don't get that. Do you want to just talk about that a little bit?

Tim: Yeah. With an ETF, every 15 seconds you're going to get an updates price. Throughout the trading day, you're going to know if you put an order for an ETF, you're going to know roughly where that order is going to get filled.

Tom Mullooly : Right to the penny.

Tim: Right.

Tom Mullooly : Yeah.

Tim: With mutual funds, you get one price at the end of the day. So if you put an order in at 10 a.m. for 10,000 shares of whatever mutual fund, you're not going to know what price you're going to get until later that evening, because you get the closing price of each day for mutual funds.

Tom Mullooly : Right. Yeah. Let's drill down on that a little bit so we're clear on that. When a client invests in a mutual fund, we can't really tell you what the price is going to be because you're going to get the closing price that day. The reason for that is, mutual funds don't trade on an exchange where their price is updated throughout the day. They've got this basket of stocks, just like a basket of stocks in an ETF, except theirs is going up, down, sideways. They've got new money coming in. They've got redemptions going out. Once the stock market closes at 4 o'clock, then their computers start crunching the numbers. What did all the holdings do today? What do we have to bring in in terms of new assets? What do we have to let go in terms of redemptions? At 6 o'clock, they'll post, "The XYZ mutual fund was up eight cents today," or "down 11 cents today." Then you do the math on the number of shares that you own.

Tim: Right.

Tom Mullooly : With an exchange traded fund, there's intraday pricing. In fact, most brokers will be able to provide what they call the intraday pricing. It's the symbol of the ETF.IV, and that will give you a price that gets recalculated every 15 seconds while the market is open. It's hard to become more efficient than that. That is really a huge thing. You're not getting stale pricing. There are going to be some arbitraged situations where the price trading on the exchange doesn't match up with the intraday value, and so the folks that make markets in these exchange traded funds have the ability to arbitrage, meaning they'll just buy ... A computer generated program will go out and mimic the basket. They'll buy everything. They will sell that back to the exchange traded fund creator, and they'll trade it for units.

Tim: Right.

Tom Mullooly : They're arbitraging this all day to keep the price close to the net asset value or the intraday value. It's a lot of work that goes on behind the scenes, but these exchange traded funds, again, are created to get you the best possible price. It's not like buying one stock. You're buying a basket of 50 stocks, 75 stocks. In the case of the S&P 500, you're buying 500 stocks.

Tim: Right.

Tom Mullooly : They're being recalculated in price every 15 seconds.

Tim: I think that's ... One word comes to mind when I think of, what are the differences between a mutual fund and an ETF. To me, it's just transparency on a bunch of different levels, pricing, sales charges, fees involved, and also the holdings within an ETF and a mutual fund. ETFs, you can see which stocks are in which ETF.

Tom Mullooly : Right.

Tim: With a mutual fund you're not getting the up to date holdings or percentages of holdings.

Tom Mullooly : Mutual funds are required to post their holdings every six months.

Tim: Right.

Tom Mullooly : That's the minimum. Some obviously now, since more people want more information, they're updating their lists more frequently, but with an exchange traded fund, Tim is right. You're going to get up to that day's holdings in an exchange traded fund. You'll know exactly, when I'm buying this ETF, it owns 11% of Microsoft.

Tim: Right.

Tom Mullooly : That's where 11 cents of every dollar you invest is going into this particular name. That's really big. Understand that mutual funds don't trade like stocks do. Exchange traded funds, like the name implies, they trade on an exchange. Anything that trades on an exchange, you're going to have the ability to enter stop orders. You can put in limit orders to buy and sell. Some of these exchange traded funds even trade options on the ETFs themselves. So it give you even more ability to do other things with your money. Some of them, as we said earlier, are just mimicking and index. That's a great way to do it very cheaply. There's others that say, "Hey, we want to do this. We want to take this index and we want to buy it on an equal weighted basis." To talk about the differences between equal weighted and cap weighted. That could be a whole 'nother podcast.

Tim: Yeah.

Tom Mullooly : We would just go in and buy ... They build sector ETFs. They'll put together ETFs based on themes. We just did a video on the Quincy Jones.

Tim: There's a new ETF out there. I think it's ... The symbol is QJ, for Quincy Jones. He's pretty much just lending his name to the fund, but it looks for companies that are involved in music streaming and entertainment stuff obviously that Quincy Jones would be involved in. But yeah. You can get really specific nowadays with these ETFs.

Tom Mullooly : Yeah. Just a few others that come to mind, they have one for mobile payments, so companies that are involved in mobile payments. Think PayPal, Venmo.

Tim: Right.

Tom Mullooly : Think of other companies that get involved in this that are publicly traded or involved in it. So the symbol is IPAY.

Tim: IPAY.

Tom Mullooly : Then they have nother one that is just involved in companies that are involved in the drone business, and it's called IFLY. We're not recommending any of these. So please don't take this as a recommendation to buy or sell any of the investments that we're talking about in today's podcast. We're doing this to illustrate that ETFs began as a way to mimic and index. Then it became ways to differentiate an idex cap weighted versus equal weighted. Then they started drilling down into sectors. Now they're drilling down into themes. There's a lot of ways to put this baby together.

Tim: Right.

Tom Mullooly : There's different ways to look at exchange traded funds, but understand that whether you're going into a mutual fund or going into an exchange traded fund, we're talking about a basket of stocks. There is an entrenched army in the financial community that has built their entire careers around mutual funds for investors. I still think, in 2017, there is an awful lot of resistance to everyone getting behind exchange traded funds. It's only because they are paid and paid well to show these investments to their clients.

Tim: Right. I forget who said the quote, and I'm going to say it wrong. But it's something along the lines of, "It's hard to believe in something if you get paid to believe the opposite." Kind of reminds me of people who get paid to sell these mutual funds. It's hard for them to tell their clients about ETFs when they're not going to get paid on it.

Tom Mullooly : Right. That is something that kind of naturally fell in our lap when I began the business 15 years ago. It was a fee based on the value of the account. We forsake commissions. We don't take commissions for out clients. In fact, we want to keep your commission cost as low as possible.

Tim: Right.

Tom Mullooly : So we're not going to be showing you a mutual fund that's got a sales charge built into it.

Tim: Especially when there's ... Especially now. Almost definitely an ETF that tracks the same basket of stocks and most likely does it for less.

Tom Mullooly : We can probably find an ETF that will track everything. What's interested is that the largest bond fund in the world recently was the PIMCO total return fund.

Tim: Right.

Tom Mullooly : PIMCO went out and they made an ETF of their fund. So you can buy it now as a mutual fund, or you can buy it as an ETF. A lot of mutual fund families are discovering that people just like the idea that they can own this structured as an ETF. So they'll take the same investments and they'll wrap it up as an ETF.

Tim: Yeah.

Tom Mullooly : So it gives investors more options to talk about. We've seen more and more articles that are popping up talking about ETF buyers are driving the markets higher or driving the markets lower. We wanted to just take a little time to talk about why this may be really misleading. I don't think it's helpful when we see these kind of articles out there. Sometimes these are positioned as passive investments because ETFs began as index replacements. But you can certainly be a lot more strategic or tactical with these. There's a lot of things for a lot of people in ETFs. So it's hard to just brand ETF buyers as passive investors. On the other hand, I wouldn't necessarily call them flippers either.

Tim: Right.

Tom Mullooly : Before we tip into what's happening in the media, I think it might be a good point here to just briefly talk about some of these leveraged and inverse funds. Because they do exist and people see them out there. You can buy things. A lot of them are often tied to an index or a commodity, and we'll see two times the index or three times the price of gasoline, or three times the price of gold on the inverse side. When you're talking about an inverse fund, the make up of that portfolio is going to be mostly treasury bonds, cash, meaning a cash holding, and puts, or where they've sold calls. They're basically betting on the price either staying the same or declining. When you get involved in an inverse fund, you're betting on something going down. When you're buying a leveraged fund, you are looking for two times or sometimes three times the move in an index or a sector.

Tim: Right. Obviously if you buy a leveraged fund, you're hoping that it goes up.

Tom Mullooly : In most cases. Right.

Tim: In most cases.

Tom Mullooly : Right.

Tim: If you were hoping it would go down, you would buy the inverse. Because I can't think of a reason you would buy a leveraged fund hoping it would go down. Because then you would get two or three times the move down.

Tom Mullooly : Right. Which does happen.

Tim: Right. Yeah. Obviously.

Tom Mullooly : It's important to know ... And this is something that I think a lot of retails individual investors miss, is that with these leveraged funds and these inverse funds, it is measured against the daily price. So if you are ... Say you're buying a leveraged fund that measures against the S&P and the S&P goes up 10%, and you buy a three times leveraged fund. S&P goes up 10% in a year, what are you going to make? A lot of people would say, "30%."

Tim: Right.

Tom Mullooly : But it's based on the daily price. It's not based on the monthly, quarterly, or annual number. You have to be really careful with that. There have been several instances where people have made more money owning a straight fund than they made in a leveraged fund. Leveraged funds do have a place for the gambler out there. Understand that it's going to make a daily move in price. It's not a long term investment. The fees are significantly more than what you're going to find when you buy some of the more popular ETFs, and they're really misunderstood. Let's talk about some of the points that we've been seeing mentioned in the media about people who are just talking about ETF buyers like they're evil.

Tim: Yeah. There's articles out there saying that some Etf people that are buying all of these ETFs are making the stock market rally, or they're propping it up. People saying there's been a boom for passive investments, are making ETFs more popular, but then it could also hurt the market when they dump these ETFs. When you read that in the same article it gets you scratching your head. Because how can these ETF buyers be passive if they're going to trade in and out of them when the market goes up and down?

Tom Mullooly : That's a good point.

Tim: That's the opposite of what passive is.

Tom Mullooly : Yeah. A passive investor is someone who is going to buy and hold and not make changes.

Tim: Right.

Tom Mullooly : A few paragraphs down, they're talking about how these passive investors could just decide to dump their ETFs. Didn't really make a whole lot of sense. It just really displays the point to me that there's still a lot of uninformed people, not only as investors, but people in our own industry that don't understand how these things work, and they just don't seem to be able to get a grip on what they're doing.

One of the best exercises I've had for clients that have pointed out these kind of articles to me, is to tell them to go back and reread the article, and wherever you see "ETF," cross it out and replace it with the word, "stock."

Tim: That's what it is.

Tom Mullooly : Because that's what it is.

Tim: Unless it's a bond ETF. In that case then use bonds instead of stocks. That's like what we said. It's a basket of stocks. If you think that ETF buyers are propping up the stock market, then you really just think that stock buyers are ... Because that's what you're buying.

Tom Mullooly : Right. Yeah. There's this Wal Street Journal article that came out last week, ETF Buyers Propel Stock Market Rally. Let's cross out "ETF" and just say, "Stock buyers propel stock market rally." That's usually how it works.

Tim: I don't know how else it could work.

Tom Mullooly : Yeah. They talk about the rising popularity of funds that track indexes. That's kind of how this business began, but that's not everything that ETFs offer.

Tim: Right.

Tom Mullooly : I think there's this misunderstood idea that people are just buying these fang stocks or these technology stocks, or they're just buying the S&P as a basket. There's a whole lot more going into exchange traded funds. One of the points that we learned recently is that since 2009, the mutual fund industry has seen nearly a trillion dollars come out of mutual funds. It has to go somewhere.

Tim: Right.

Tom Mullooly : Some of this is going to wind up in a bank. Some of it's going to wind up in individual stocks. Our guess is a lot of this has wound up in exchange traded funds. I don't really ... They quoted in this one article, this guy, "The risk is blind buyers turn into blind sellers." I don't know. It just seems to me that they're ... they're really not ... They're not presenting an actual picture.

Tim: Yeah. It feels to me like some of these people are just hating on ETFs because they don't know what they are. It's like, "It's the different thing."

Tom Mullooly : It's something new.

Tim: Yeah. Then people don't like change.

Tom Mullooly : Right.

Tim: The people that are resisting the change or the shift towards ETFs, come off as haters.

Tom Mullooly : One of the reasons behind the change from mutual funds to ETFs is the difference in how things get taxed. Let's talk a little bit about that.

Tim: You're not going to have ... On a yearly basis, you're not going to have these capital gains taxes in an ETF that you would see in a mutual fund. It's more tax efficient to own these ETFs than it would be in most cases to own a mutual fund.

Tom Mullooly : Right. If you buy an exchange traded fund at $25 a share and you sell it two or three years later at $35 a share, you've got a $10 a share profit. That is the profit and it's a long term gain because you held it for more than a year.

Tim: Right.

Tom Mullooly : Okay? Now, with a mutual fund if you put the money into a mutual fund, remember some of these fund holdings were in there way before you got mixed up with this. If they decide that they're going to unwind IBM and they've owned IBM in this particular fund that you own ... Say you buy it in July and they are going to clear out their position in IBM in October, well they could have owned that since the 1970s.

Tim: Right.

Tom Mullooly : There could be 40 or 50 years of built up capital gains, and even though you're only in the fund for a few months in 2017, you are going to be responsible for that capital gain that came with that position even though you only participated in that for a few weeks. Yet, you're going to be responsible for 40 or 50 years of gains on that. Every year you're going to have capital gains. They do get added back into your cost basis with mutual funds. We hate getting phone calls from accountants in March and April when we've sold a mutual fund for a client in a taxable account, because they're like, "Okay. When did they buy this? At what cost? And where were the capital gain distributions and how are they reinvested?" There's a lot of backtracking and paperwork that we have to go through to figure out what the actual net taxable gain or loss is on these crazy investments, and they're very expensive to own.

Tim: Yeah. Just more complicated when it comes down to it.

Tom Mullooly : Exchange traded funds, simple. You buy it at 25, you sell it at 35, you made ten bucks.

Tim: Yep.

Tom Mullooly : And you own 1,000 shares. Pretty easy. Well, look. We're going to have more questions from you, our listeners, we appreciate you hanging in there with us, as it was one of our longer podcasts. But thanks for listening to episode 186, and we will catch up with you on the next one.