MAM 192: Tim & Tom Answer Your Questions - Transcript

Tim Mullooly: Welcome back the podcast. This is episode number 192. This is Tim Mullooly and here with me as always is.

Tom Mullooly: Tom Mullooly, welcome.

Tim Mullooly: Happy to be here. We're going to continue to answer some questions for you.

Tom Mullooly: From our mailbag.

Tim Mullooly: Yep. Our deep mailbag. The questions just keep coming in so we're going to keep answering them for you.

Tom Mullooly: Now some of these topics may be relevant to you but sometimes we take these questions and we kind of go off a little bit on a tangent because sometimes there's a bigger issue behind them and I think that's going to be the case with a few of the questions that we tackle today. So Tim, why don't we jump right in and go to the first one?

Tim Mullooly: Sure. The first question asks, “what’s a reasonable suggestion for a company 401K match amount?”

Tom Mullooly: That's what they're the expecting the company to match?

Tim Mullooly: Right. They say, "My company doesn't currently match 401K contributions however I'm about to negotiate for a new compensation package and have been asked to include all elements that are important to me. What is a fair contribution for a company to match?"

Tom Mullooly: Well remember if they match for you, they've got to match for everybody. If you're asking the company to match 5% of your salary then, or 10% or 3%, whatever the number is. Remember they have to do that uniformly for everyone that contributes to the plan and they have to be prepared as a business to make that contribution for everyone on the payroll.

Tim Mullooly: Right. For one individual to ask an company to match for everyone's 401K contributions is a big thing to ask, in my opinion. Not really something that I foresee a company being willing to negotiate with just one employee.

Tom Mullooly: I think you should negotiate for a parking space before you negotiate for a 401K match. There's other things that you should be negotiating. That's probably not negotiable.

Tim Mullooly: Agreed. Okay, so moving on, next question is "how can I receive distributions from a mutual fund loss?" There's some details here to the question. They go on to ask, "I want to sell a mutual fund that will be a long term capital gain loss. The cost basis is 40,000, I will be selling at 25,000 for a $15,000 loss. There will still be $6,000 remaining in the fund. There's a capital gains distribution/dividend on December 26th. For tax purposes, will it be better to sell after the 26th or before the 26th? Will I still receive the dividend?

Tom Mullooly: Whoa. Okay. There's a lot to unpack with this question. The first thing I want to address is the question about selling and taking the loss. Are you going to file as a LIFO filer? Meaning L I F O, last in first out? Are you going to be FIFO, first in first out? Are you going to do average cost? What are you going to do? That's going to determine what your cost basis is when you're taking the loss in a mutual fund. But there's more to this as Tim went on. Read that back again, the part about 26th.

Tim Mullooly: Sure. The question says, "There is a capital gains distribution/dividend on December 26th. For tax purposes, will it be better to sell after the 26th or before the 26th? Will I still receive the dividend?"

Tom Mullooly: Okay. Let me give you an example as a way of answering the question. Suppose you own shares of a mutual fund that are trading at $56 a share. On the 23rd, 24th, 25th, it's trading at $56. Now they're going to pay $6 a share in capital gain distributions on the 26th. What happens to the price of the shares on the 26th?

Tim Mullooly: It gets adjusted for that distribution that they paid out.

Tom Mullooly: So it's $56 and they pay a $6 capital gain distribution. The price of the share is now $50. If you sell it on the 23rd, 24th or 25th, you're going to sell it for $56. If you sell it on the 26th you're going to get?

Tim Mullooly: $50 a share.

Tom Mullooly: $50 a share but your also going to get a distribution credited to your account for $6.

Tim Mullooly: What we're trying to say here is that it doesn't really matter.

Tom Mullooly: It really doesn't matter, but this kind of now spills over into another topic and that is something we used to spend a lot more time talking about. We do less and less transactions every year in mutual funds at Mullooly Asset Management. Part of it is because of questions like this. I think what a lot of people don't understand, and again this is an example where someone got mixed up in an investment that they don't understand, you're going to hear that theme again later, where ... Let me give you a story that might give you a better snapshot of what I'm trying to describe.

We had a client, passed away 20 years ago in the 90s, his widow came to me, we have to sell the mutual fund. Okay, fine. What did you pay for it? What's the cost basis. Well I don't know. My husband bought this fund in 1969 and he put $10,000 into it. And it's worth $109,000. So according to her, she thought she had a $99,000 capital gain that she had to report and pay taxes on.

Tim Mullooly: It's hard to blame her for thinking that.

Tom Mullooly: Yeah, a lot of people think.

Tim Mullooly: It just makes common sense. You would think that's the way it would work. These mutual fund are a little different than that.

Tom Mullooly: If you own a stock that you put $10,000 in and you sell it for $109,000, that math is right.

Tim Mullooly: Right.

Tom Mullooly: Same thing with an ETF, with an exchange traded fund. But with a mutual fund, little different. Your capital gains every year get added, underscore added, to your cost basis. So we went back and we did our homework and found out the cost basis for the capital gains distributions for 1969, 1970, 71, 72, 73, 74, all the way up until the point that this fellow passed away and his cost basis now with all the capital gains reinvested back into it, his cost basis was $19,000. So instead of having a $99,000 taxable gain, she actually had a $19,000 capital gain. Now I'm going to twist this story one more time around in this.

They sold this right before her husband passed away and it was in his name. So the whole transaction was taxable to him. She had power of attorney and did this. It would have been significantly better, since it was in his name, for him to pass away, leave it to his surviving spouse, she would get the stepped up cost basis, no capital gains. She would inherit the fund shares at the value on the date of death. So there would be virtually little to no capital gains whatsoever. But they needed the money, what are you going to do? Mutual funds sound good when you first hear about them, very complicated though when you're trying to do the math.

Tim Mullooly: Right. And that's how they get sold in my opinion. You keep it simple enough so that people can understand the good benefits about it but then there's a lot of stuff underneath the surface. All the complicated details that make it seem so simple.

Tom Mullooly: Right.

Tim Mullooly: Not really that simple. And sometimes can create some confused customers on the way out.

Tom Mullooly: Absolutely right. Okay, what's next?

Tim Mullooly: Move on. The next question says, "Where can I put excess cash so that it can grow and remain accessible?" After retiring at age 67 and downsizing, I find I have too much cash on hand. Savings accounts and CDs are safe but at the current interest rate I feel like I'm being taken advantage of.

Tom Mullooly: Stop right there. Just read me that last sentence again.

Tim Mullooly: Sure. I feel like I'm being taken advantage of.

Tom Mullooly: Go on.

Tim Mullooly: "What would be a good place to put my money to grow with minimal risk yet still be able to access if need be?"

Tom Mullooly: Big sigh.

Tim Mullooly: There seems to be one big sigh per episode.

Tom Mullooly: Right. Basically what this guy wants is nirvana. The rates at the bank are really bad so I want you to pull something out of your advisor magic hat and do your spell on it, wizard advisor, and give me something that's going to be totally liquid, risk free and I'm not going to be greedy, just give me 5 or 6% interest.

Tim Mullooly: I don't even know how to respond to something like that.

Tom Mullooly: I know how to respond. I want what you're smoking dude. It just doesn't work that way. If you want to be risk free, the risk free return is zero. That's what it is. If you want to be risk free and liquid, you're going to get money market kinds of rates and you're going to need a microscope to see the yields on these things. That's just the way it is. But I want to address that, what was that line that he put in?

Tim Mullooly: I feel like I'm being taken advantage of?

Tom Mullooly: Oh yeah. I got a little problem with this. I totally get it. If you saw CD rates in the 70s and even into the 80s where banks were paying, every time I say a number someone else says, "Oh, I got a higher rate than that." But my dad came home one day with a three month CD that paid 20% interest.

Tim Mullooly: Wow.

Tom Mullooly: But it's annualized at 20% so he only got three months of interest. A quarter of that. But for a long, long time, we saw in the late 70s and into the early 80s, we saw double digit interest rates. And so getting 10% on a CD happened more than it should of. But here's the thing, your risk free rate of return, like on a CD or a money market, is a factor primarily of inflation. If inflation, if you're getting 10% on a CD, the odds are, without even looking too hard, I can tell you that the average annual rate of inflation at that time was probably eight or 8-1/2%. You're getting a net 1-1/2% on a CD.

Tim Mullooly: Sounds pretty normal.

Tom Mullooly: Maybe two.

Tim Mullooly: Right.

Tom Mullooly: Yeah. Now everybody is bellyaching that they're getting 1% on a CD. Where's inflation? It's pretty much zero. These rates on a net basis are not much different than what we saw 30 years ago, there's a not.

Tim Mullooly: There's a big difference between real returns and nominal returns. That's just another thing that the everyday individual doesn't understand.

Tom Mullooly: Do you remember about 10 years ago, we used to see these commercials for Orange and the ING money market fund. They were paying 4% interest, and people still remember, wasn't all the long ago, wasn't even 10 years ago. People remember these, they didn't have rules, or they didn't enforce rules prior to 2008 on what you could hold inside of a money market and let's be technical, the actual name of a money market is a money market mutual fund. You own a basket of investments that every night like magic would add to $1 per share. If you had an account with a broker in 2007 or 2008, you would get a statement and it would say, you own 61,210 shares of a money market mutual fund at $1. They wouldn't say you have $61,210 in cash, they would say, you own 61,210 shares at $1 each.

What happened in 2008? Much longer story, we can do, matter of fact we did do a entire podcast on this. These money market mutual funds, all of a sudden the investments inside of them didn't add up to a dollar. Problem.

Tim Mullooly: Big problem.

Tom Mullooly: And yeah, that phrase was called breaking the buck. Soon after 2008 came and went, the SCC changed what money market mutual funds are eligible to hold as investments inside of them. I forget the exact numbers but basically about no less than 80% of the money in a money market fund can be invested in T bills. Treasuries. If you want to get an idea where interest rates are going, look at a 13 week T bill. Slice off a little bit of a profit for whatever bank you're dealing with and that's going to be the rate on your money market fund. That's going to be it.

Tim Mullooly: This guy's question, it just makes us shake our head here. There's a couple things that you could do. If you're trying to grow the money, you have to introduce a little bit of risk. There's no way around it that we know of right now. Or keep it safe and keep it out of the market. You can't do both.

Tom Mullooly: These folks and I can even tell you what kind of age bracket they're in, think about it, they had money sitting in the bank in the late 70s and early 80s, 35 years ago, almost 40 years ago, and they said, without any taking any risk in the stock market I was getting 13% on a CD, then 11, then nine, then seven and now I'm down to .8 or whatever the number is. They've seen that and they do have nominal returns, but they were also getting gouged with inflation at the same time. So their purchasing power, it didn't work out for them in the end.

Tim Mullooly: Right. Okay, next question. “When am I charged for an ETF expense ratio?”

Tom Mullooly: We talk repeatedly about knowing what own. Knowing your investments and just hearing a question like that means that we have a much bigger job still to be done in terms of educating our clients.

Tim Mullooly: It's always a little scary to hear people talking about these investments and they're putting their hard earned money into these things and they just don't understand how they work.

Tom Mullooly: Right.

Tim Mullooly: It's just, it again, makes us shake our heads.

Tom Mullooly: Yeah. Understand that the growth, the explosion of exchange traded funds has occurred in the last couple of years because investors in general are getting fed up with paying fees in mutual funds that were pretty steep. So you would have, say, a bond mutual fund that could have an expense ratio of 75 or 80 or 85 basis points. Now you can find an alternative that may have 12 basis points. It may virtually be the same investment or pretty close to it. The difference is the cost of running the fund is a lot more efficient and a lot cheaper for investors. Investors don't get a bill for their expense ratio in an ETF, it gets sliced off in micro scrapes every day. The best analogy I can give you is if you were looking a bond ETF that had an expense ratio of 12 basis points, you'd be charged one basis point per month. Per month. That's over 30 days.

Tim Mullooly: Not a lot. It's almost nothing.

Tom Mullooly: It is. And it gets factored.

Tim Mullooly: Microscopic.

Tom Mullooly: It gets factored into the cost of running the fund on a daily basis. These computers are pretty good now. They can go out five, six, seven, decimals and figure out what the daily cost of these funds are. So if you own an exchange traded fund with 40 basis points, do the math, over 360 days, this is how they're going to calculate this. So every day, a little tiny microscopic slice comes off the net asset value. You don't get a bill for this. That's just the cost. If you were measuring it against a well-known index, look at the index, subtract the expense ratio, you're going to be pretty close to your total return.

Tim Mullooly: Right.

Tom Mullooly: Again, I can't stress this enough, Tim, we have a lot of work to do in terms of educating investors about how these things work. And please don't put your money into something you don't understand. Talk to an advisor, be great if you talked to us, but don't feel obligated. Talk to an advisor about how these things work.

Tim Mullooly: We have a couple more questions here that we're going to try and get through. Next up is "how risky is investing in treasury bills?" The secondary question is where are treasury bills on the risk spectrum of investing? There pretty much as low as you can get.

Tom Mullooly: I agree. The one thing that I will add is that no matter what investment you own, especially one with a maturity date, T bills, the average maturity on a treasury bill is 13 weeks, that's three months. If you sell an investment like a treasury bill before maturity, you could make money, you could lose money, you may not get your original investment back. Treasury bills, unlike a lot of other fixed income investments are sold at a discount and they come, when they come due, they come due at 100 cents on the dollar. You may be foregoing more than just your interest if you sell treasury bills before the actual maturity date. If you are a treasury bill investor, don't plan on tapping into that money until they mature. It's not that far away, it's only three months.

Tim Mullooly: When I first read that question my initial response was compared to what?

Tom Mullooly: Yeah, how much risk do T bills have compared to ...

Tim Mullooly: Compared to stocks? Significantly less.

Tom Mullooly: Right.

Tim Mullooly: Compared to keeping your money under your mattress? There's a little bit more. There's always a chance that something could happen but like they said on the risk spectrum of investing, it's pretty much as low as you can get with treasury bills.

Tom Mullooly: I agree. Like we had just mentioned in an earlier question, the bulk of money market mutual fund assets are now invested in treasury bills and they have to maintain their $1 per share price. So you're not going to get a lot of volatility, you're not going to be taking a whole lot of risk if you're investing in T bills but for goodness sakes, if you own a T bill, don't sell it before it comes due. It's just not worth it.

People talk about T bills and they talk about treasuries and I wonder sometimes if people understand that there are several different types of treasuries. There are T bills, there are treasury notes and then there's treasury bonds. And they have different lengths of maturity. So T bill can be anything coming due within two years can be considered a treasury bill. That's 24 months. The most popular maturity for treasury bills is 13 weeks. A treasury note can be anywhere from two to five years and technically I've heard up to seven years but you get the idea. And then treasury bond would be anything beyond that up to and including 30 years. People talk about putting money into treasuries, do you know? Treasuries, long term treasuries are about as volatile as an investment as you can find. They trade 24/7 around the globe, around the clock and they're, when you start getting out to the fourth decimal, you can see a lot of volatility on a daily basis with treasuries.

One of the best examples I can give you in terms of giving you an analogy of this is someone told me once that imagine a very tall building, let's just use the Empire State Building. If you are a low risk investor and you want to be in T bills, you're basically going to stick to the bottoms two or three floors. On a windy day, you're not going to feel anything at all. When you go into treasury bonds, you're in the middle floors, still don't feel anything on a windy day. However when you go up to the observation deck, you go out 30 years in treasury bonds and there's a windy day, you're getting blown around. So that's what happens with these long term investments.

The market goes haywire and people say, "I want to get out of this, I want to get into treasury bonds." Because they've heard that they're the safest things out there. And then they find out that the treasury bonds that they own are just as volatile as stocks and it's a little scary. Sometimes people don't know what they're asking for and that's why it's important to work with an advisor because I think a lot of times when people say, "I want to get out of the stock market and get into something safe." They really should be getting into treasury bills, T bills, not into long term treasuries. They're just as volatile as stocks at certain points.

Tim Mullooly: Yeah, and these questions that we get are random but it seems like the theme here today is just know your investments, do your homework and just make sure that you always know as much as you can about where you're putting your money. Because you worked hard for that money and you don't want to lose it in some investments that you just didn't know the details about it.

Tom Mullooly: Now if you've got a question related to these topics or any other topics that would like us to cover on a future podcast or a video, by all means get in touch with us. You can call us, our phone number in New Jersey is 732 223-9000 or you can find us on the web at mullooly.net. That's M U L L O

O L Y.net. We welcome your questions there's never a cost or obligation and if it's a good question, something we can talk about, we may cover it in a future podcast or video.

Tim Mullooly: That's going to wrap up episode number 192. Thanks for listening and we will catch you on episode 193.