Mullooly Asset Podcast: Ep. 211 - Transcript

Thomas M.: Welcome to the Mullooly Asset Management Podcast. This is episode number 211, 211 in progress. I'm joined today with Brendan Mullooly, CFP.

Brendan M.: Hello, how you doing?

Thomas M.: We thought we'd take a slightly different approach and run through some of the news headlines that we've seen the last few days and just comment on how this applies to investing: whether it's important, not important, and just out commentary on some of the news of the day.

So I know Brendan's got a couple of things lined up. I've got a couple of things lined up. So if you've ever watched "Pardon the Interruption," that's kind of the idea that we want to have. This rapid-fire thing where we talk about different topics. So now, Brendan and I shared a couple of topics before we came in here to record, but I have many more topics that he hasn't seen yet. So he's trying to read upside down on my list that's in front me.

The first thing that I just want to bring up is an article in the "Wall Street Journal" today. The "Wall Street Journal" report on CEO pay compares the CEO who increased his personal income the most and how the stockholders made out.

Brendan M.: Was this Under Armour?

Thomas M.: You wrecked the surprise! So yeah, so the best in terms of returns for investors was Amazon.

Brendan M.: Well, yeah, that makes sense over the last year. And I think people probably have less issue with things when the stock does well and the CEO gets an increase in pay because that's what they're incentivized to do. But also at the same time, I've heard people raise the issue of, should that even be the metric that CEOs are paid based off of?

We tell them that their pay's going to be based off of increasing their earnings per share or whatever, so they do anything they can obviously, that being the incentive, to increase the earnings per share at the cost of ethics, the company, and sometimes the shareholders, even.

Thomas M.: There's a real danger tying your chief executive compensation to metrics like that.

Brendan M.: I think just having it be only one metric ... There have to be other measures of this value too. Just the earnings per share. That's the only thing we care about. There's so many other things. There should be a handful of metrics that you use to analyze a person's performance like that.

If there were a perfect one, it would already exist. But these are the kind of things people talk about, even what's best for the company.

Thomas M.: And just seeing what shareholders received, over the last year, Amazon is up, according to the article, 56%. Bezos did not take an increase in pay, so he was paid $1.7 million the year before, $1.7 million in this year that they measured. So no increase in pay for him. Stockholders made 56%.

Brendan M.: But also, how much of Amazon stock does Bezos own? Right, so.

Thomas M.: Yeah, he did okay.

Brendan M.: Totally, he's doing fine. That's kind of interesting, he didn't take any kind of a pay increase, but he's always been kind of an eccentric leader anyway in terms of what he will and will not do.

Thomas M.: This was a guy who I think 10 years ago when "60 Minutes" interviewed him, he was driving a Honda Accord. And he's like, "What's wrong? It's a good car."

Brendan M.: I always liked ... I'm pretty sure that this was Bezos, so forgive me if it wasn't. But I think they were talking about the Fire Phone or something and how much of a failure it was, and he was like, "Yeah, it was a total failure. And we're going to have more total failures just like that one in the future and maybe even bigger ones, probably bigger ones."

I love that mentality of, "Yeah, we're going to fail, and that's okay." And it has been okay, obviously.

Thomas M.: Yeah, they're failing their way to a success. So speaking of failure, if you want to call it that, at the opposite end of the spectrum, Kevin Plank.

Brendan M.: Right, that was the premise of the article. He was the picture on there with Under Armour. So he got a big increase in pay, and the stock was cut in half basically.

Thomas M.: I wouldn't want to be his PR guy right now. He's having a tough year.

Brendan M.: Bad optics, I think.

Thomas M.: Yeah, the stock is down 50%. His pay is up 100%, so he went from around $2 million to $4 million. So his pay doubled. Everybody lost money involved, but he's the biggest shareholder in the company too. So he's suffering right alongside it as well.

Like you said, Brendan, I think this is an unfair metric to use. But it sure makes for good headlines.

Brendan M.: Yeah, there's no good way to sell that disparity in terms of his pay increase and the stock's performance but also stock's performance over one year could be complete noise. We know that very well, but ...

Thomas M.: And one year is such a small window.

Brendan M.: Yeah, so it's tough to say. Right now it looks bad, but if we're a decade from now and Under Armour is still competing with the likes of Nike and Adidas and has become a bigger company and the stock price has translated, then who cares? But it's tough to say now whether it'll be that, or if Under Armour just goes under or is bought out by somebody else. We don't know.

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Brendan M.: So I saw one in the past week that was ... The title was "How the Oil Rally Took Forecasters by Surprise."

Thomas M.: Okay, so was it Morgan Housel? Or who was it that made that quote? I think we all retweeted it.

Brendan M.: Yeah, so I actually saw something that he wrote today, and he was actually referencing Danny Kahneman. And Kahneman said that the correct lesson from surprises is just that the world is surprising. And Morgan was kind of saying that the problem is we take surprises or things that we were wrong about and try to learn specific lessons from them, like in the tech bubble that internet stocks were bad, instead of just recognizing that we need more room for error.

So more room for error means less ego and means being ... You can still make forecasts, but you should be able to recognize that there's a very high probability that you could be wrong. Or you should at least recognize the probability even if you feel sure about it.

Thomas M.: I think the big takeaway from the tech wreck was that eyeballs mean nothing because analysts were saying, "Look at the eyeballs, the impressions that they're getting." And it turned out to be totally nothing.

Brendan M.: But the naysayers got called idiots for four, five years before that because "The fundamentals don't matter. This is the new economy." And they were right. But they were too early. So it's like their forecast may as well have been wrong for three, four years while these stocks continued to skyrocket.

Ultimately, they were proved right, but I think the macro lesson here, so to speak, is just that forecasting is really hard. And that we all need to recognize that forecasts don't always come true and that they are just guesses, hopefully educated ones. And that we should leave space to be wrong.

So if you're making investments based upon forecasts, which all of us do ... We all have beliefs about the future regardless of how strongly held or what they're based on: fundamentals, technicals, whatever it is. We're all making forecasts, but we should be able to recognize that we probably need to do something like diversify or have margin for error because we're going to be wrong about a bunch of stuff.

And we just want to be able to be right enough so that we're not blown up.

Thomas M.: Right, and I think the tweet that we all saw was "Earnings didn't miss estimates. Estimates missed earnings."

Brendan M.: Right, yeah, and that's true. I kind of went off on a tangent there, but Morgan did say that too.

Thomas M.: So one of the bigger stories this week in the news has been what's going on in the emerging markets and the US dollar.

Brendan M.: Off of the lows, which were back in February, the dollar is now up like 5% or 6%. On the year, it's up like 1% or 2%. But when you see reversals of trend in currency like the dollar, you start hearing a lot about what is and is not correlated with the dollar, what this move in the dollar is going to mean. It's tough to say sometimes because it depends on over what time frame.

So a move in the dollar over two to three months, like what we're seeing now can be meaningless. It may or may not impact US or international stocks, not sure.

Thomas M.: One of the headlines that we saw the last few days was how global growth is stumbling in 2018, but we only have numbers through April, if that. They're all going to be revised.

Brendan M.: We'll change the story in October if performance has improved. It's all the performance driving the narrative. But yeah, we're looking out the rearview mirror now. I think at the beginning of the year, I'm not sure ... I didn't see many people predicting that the dollar trend was going to reverse. And even if they did, you could look at a year like 2016.

So most people would say, "If the dollar's going up, that's bad for emerging market stocks." That's a pretty well-known correlation.

In a year like 2016, we saw the dollar up I think somewhere in the realm of 5% or 6% on the year, and emerging market stocks were up 10% that year ahead of large-cap US stocks, S&P500, developed markets. So great, take your correlations and throw them out the window.

Thomas M.: The story didn't fit the narrative. Again.

Brendan M.: Right.

Brendan M.: So it's good to know what is going to drive correlations because these things tend to be true, generally, over longer stretches of time, so you can construct a portfolio that works that way. So if you're looking at the dollar today and you have a diversified portfolio, something that might be helped over the long term by a move up in the dollar could be like small-cap US stocks.

Great, we have some exposure there. So that's good. Maybe the emerging market stocks aren't doing as well because of a move in the dollar. Okay, we have some exposure there too, and when that trend reverses, then emerging markets are going to lift us in a falling dollar environment. And the small-cap stocks are going to lag a little bit.

Thomas M.: It's also ... I can't think of a clever analogy, but it seems like when a group moves into favor, we start getting a lot of calls from people saying, "I see everyone's talking about oil. Don't you think we should have oil?"

Well, you should've had it by now.

Or, "Everybody's moving into bonds. Don't you think we should have some bonds?"

Well, we should've had it, or you should've had it by now.

Brendan M.: What you're actually asking with that question ... What you're saying, basically, is that you want six-months ago bonds.

Thomas M.: Right.

Brendan M.: You're saying ...

Thomas M.: Can we go back in time?

Brendan M.: Yeah, and we can't. So if there are things that we think belong in our portfolio, we should be analyzing them regardless of the situation that's going on. So we don't care whatever direction oil is going in. We obviously know it can go up and down, and it's going to do that over the time that we own it. What would be the thesis for having this in the portfolio? What purpose does it serve, and what's our reasoning for owning it?

Thomas M.: It's a good thing we have that flux capacitor though. Yeah, we can go back in time.

Brendan M.: Just in case, we can hop back in time. It'll be good.

Thomas M.: So I did pick up a couple of little tidbits about what's going on in Argentina. Inflation right now is running at 20%. We are freaking out in the United States about whether inflation will be 2% or 2.25%. Argentina, the inflation rate over the last 12 months is 20%. The central bank last week raised their rates to 40%, 4-0 percent.

And one of the arguments was, "Yeah, but only 15% of their imports in Argentina come from the US. So why should a rising dollar hurt them?"

What I found was 88% of imports are actually invoiced in US dollars, so practically everything coming in is being paid out in dollar. It may not come from the US, but that's the method of payment. So a rising dollar is going to really hurt them.

Something else I think a little more closer to home is that short-term bond funds in the last month, in the month of March, pulled in $168 billion.

Brendan M.: Right, so these are one- to three-year bonds?

Thomas M.: Correct. And this is short-term bond funds meaning short-term bond mutual funds and short-term ETFs.

Brendan M.: So people are worried about having too much duration in a rising interest rate environment?

Thomas M.: Right.

Brendan M.: So longer bonds are going to be hit the hardest as interest rates are rising, and we've seen that. Things like the 30-year T bond, the price has to come down more to justify a change in interest rates.

Thomas M.: And taking on the time that you're going to be tied up in a 20-year or 30-year investment.

Brendan M.: Sure, opportunity cost.

Thomas M.: Right, so the price is definitely going to be moving. But this kind of leads to another discussion that we have with clients a lot about bond funds versus individual bonds. So one of the big discussions is, "Hey, if we own bonds, interest rates can go up, down, sideways, I know that in some point in the future, I'm going to get back at maturity, I'm going to get back my original investment. That's better than being in a bond fund where they're constantly flipping over the bonds in the portfolio."

What's your take on that?

Brendan M.: Yeah, I don't agree. So one of the big issues I have with that argument is first off that when we see interest rates go up, it usually means that there has been some kind of inflation in the economy. So when you're getting your nominal dollars back from your individual bond purchase in the future, they're worth less.

So yeah, you're getting your $1,000 face value back on the bond, that maturity, but it's not worth $1,000 anymore because of inflation.

Thomas M.: People miss that.

Brendan M.: Yeah, also, why are we owning the bonds? Because if you're owning ... So I could see a case being made for lining up a need in the future, like you know your kid's going to college in 10 years, so you buy a 10-year bond. And you know exactly what you're going to have 10 years from now. Great.

Most people don't own bonds for reasons like that. They own them constantly in their portfolio. They want constant exposure to some degree because they're using them to offset the stock risk. They're using it to diversify.

In that case, you're going to take your dollars that you get at the end of the bond terms and roll it into a new bond, which you could've done at any point over the life of that bond itself. That's exactly what a bond fund does for you, actually.

Thomas M.: So they're picking up the additional yield as you go further along.

Brendan M.: So when rates are going up, you're going to take initial losses in the short term for the first year or two if this is like a constant, rising-rate environment. You're going to take initial losses as the interest rate moves happen, but as that portfolio of bonds has issues coming due, they're rolling over into new bonds with higher-yield payments.

And those higher-yield payments are eventually making up for the principal losses that you took along the way. So you start coming out breakeven, positive, even in a rising-rate environment. And you're doing it at a very low cost, which you are not going to do owning individual bonds.

Thomas M.: Well, we've been saying all along. Before we walked into the room to record, Brendan and I have both said this on different videos and podcasts, that bonds trade by appointment. And that's something that we're going to get to in a later podcast as well. So it's important to understand that the value you see on your statement may not accurately reflect what the bond is worth today.

And so applying this whole idea that you just laid out towards short-term bond funds, if you've invested in a short-term bond fund and they own things that come due in 6 months, 12 months, 18 months, 2 years, they're going to be very quickly capturing higher and higher yields.

So those short-term bond funds are going to reflect a lot faster increases in rates.

Brendan M.: Right. Also, part of me ... And this is just silly contrarianism. I have nothing to back this up. But if people are going to the short end of the duration spectrum, it almost leads me to believe that this risk is overblown and that people are going to regret this like they have for the last ... Rates have been rising now for a year and a half or so, but before that, you heard for a decade how interest rates had to come up.

They had to come up, and they had to come up. And meanwhile, people who just hung out in their bond funds and let them do their job were perfectly fine and made good money doing it. So

I don't know. Time will tell if people are making the right call or not, but yeah, I would agree that in a shorter-term bond fund, you're going to see the benefit of higher interest rate payments come quicker than a bond fund that average maturity is 30 years.

Thomas M.: Okay, so a couple of quick questions before we wrap things up. Yesterday, the Mets trade Matt Harvey for Devin Mesoraco. Your take on this?

Brendan M.: Good riddance. If he can turn around his career, then good for him. It was time to let him go.

Thomas M.: Okay. It's also been announced that the Yankees are going to be playing the Red Sox next year in London. Your thoughts?

Brendan M.: I don't like these changes from baseball trying to cater to the average person. They're turning away real fans of the game with stuff like ...

Thomas M.: It's like watching baseball on Facebook.

Brendan M.: Yeah, I don't want to do that. I just want to watch baseball, and I don't want a pitch clock. And I don't care how long games take.

Thomas M.: Or how many visits, mound visits.

Brendan M.: It's baseball. I don't care. I just want to watch the game that I love, and I feel like they're forsaking the true baseball lovers to try to grab the marginal fan. And I don't care about those people. I care about me.

Thomas M.: Last question for episode 211, 211 in progress. How many browser tabs do you have open right now?

Brendan M.: I'm not sure, but if I'm going on the average, probably like 8 to 10.

Thomas M.: Eight to 10? You're slacking today. So I have 21 open right now. So that's it for episode 211. Thanks for tuning in, and we have a lot more to talk about in episode 212.