Mullooly Asset Podcast: Ep. 212 - Transcript

Tom Mullooly: So we're into the area code section of the podcast. This is Episode 212. That's the New York City area code, 2-1-2. Our next podcast will be from Los Angeles, area code 2-1-3.

Brendan: File that away with useless knowledge, right?

Tom Mullooly: That's right. Dallas, Texas after that, 2-1-4. We'll be back on the east coast with Philadelphia with 2-1-5.

Brendan: How do you know this?

Tom Mullooly: I spent years and years cold calling all these area codes. Cleveland is 2-1-6. I think Wisconsin is 2-1-7. I give up after that. I think Indiana is 2-1-8, but don't quote me on that.

Brendan: Just food for thought, I chuckle when ... because I know the answer to that obviously that you came up in the business cold calling. That's why you know all these different numbers. And we kind of laugh, reminiscing ... Well, you're reminiscing, I'm just imagining. But you came up in the business that way, and it seems funny to us now that people would buy stocks over the phone from somebody cold calling. So what do we do today in our line of work that we will think is funny 20 years from now?

Tom Mullooly: That's a good question.

Brendan: There's no good answers, there's no right or wrong answers, it's all speculation, but it's interesting to think about because I'm sure you didn't think it was crazy at the time. That's how people did business at the time. That's how you invested in stocks. You didn't sell any other way.

Tom Mullooly: That's how we did it.

Brendan: Just something popping into my brain as we're getting started here.

Tom Mullooly: So in Episode 212 of the Mullooly Asset Management podcast, Brendan and I are going to chip away at some of the news headlines that we see in our line of work, and we may throw in a golf reference or baseball reference along the way as well. So Brendan, you came up with something that you wanted to mention right away.

Brendan: Yes. This was in the Wall Street Journal today. Starting next week, you can see brokers' profits from bond sales.

Tom Mullooly: That's pretty interesting.

Brendan: Yeah, I mean I'm sure you could share stories from the brokerage world over the course of your career, but the premise is basically that now when you get your trade confirms from a broker, if they're trading individual bonds for you they also have to include the spread that they and their firm often get. This can be as much as three percent sometimes. It's probably less in most cases in today's world, but it can still be higher than that depending on how thinly traded the bonds are in question.

Tom Mullooly: I understand that bonds -- and we've said this before on different podcasts and videos -- bonds trade by appointment. There'd be times in years gone by on the brokerage side where the bond desk would have an inventory of 200,000 or 500,000, whatever, of a corporate bond with a yield, and they would offer it out to brokers with two points in it, three points in it. That's a two or three percent commission for buying the bond. Of course, you can also take a commission on the way out as well, but they were always built into the price so the client never saw how much they actually paid.

There were some pretty savvy bond buyers that I bumped into early in my career who, I would call them for bonds and show them what I had in inventory, and the question would immediately come up, "Is that the best you can do?" And I kind of felt like I suddenly was being put on the same level as a car salesman. Is that the best you can ... Oh, let me go talk to my manager and we'll see what we can do to get you into this Dodge Dart today. So these prices are negotiable, and so for the first time in my career, I'm pretty happy to see that investors, if they read what shows up in the mail ...

Brendan: Yeah, I'm not totally sure that that will happen, but ...

Tom Mullooly: If they do read the trade confirmations, they're going to see what they are paying in these bond transactions. And I think the days of four points on a bond, I think they're pretty much gone. But you'll be surprised from one firm to the next how some folks will be able to buy and sell municipal bonds for a quarter of a point. It's a good deal. And then others, you're paying a lot more; three-quarters of one percent, something like that.

Brendan: There are always going to be trading spreads, too. You're going to have trading spreads in stocks and ETFs, too. And these exist because people make markets and they get paid to make the markets. And if they didn't, then there would be no liquidity and nobody could trade. So they've got to make some kind of money. I totally get that that aspect of it, while it gets compressed, is not going to totally disappear-

Tom Mullooly: It won't.

Brendan: -because then nobody would do it.

Tom Mullooly: It won't go away. And understand that the bond desk is a profit center for the brokerage firms, and so there will be a spread between the bid price, where you want to sell it, and the ask price. And then there is the broker markup, which is what is added to the purchase price, or the markdown, when you go to sell it.

Brendan: The thing that pops into my brain for the average investor is that this is another reason to just own a bond mutual fund or ETF, because while you pay an expense ratio each year in a bond mutual fund or ETF, you can find some very, very low-cost ones in the realm of a few basis points and up, depending on what kind of strategy-

Tom Mullooly: We know some that have expense ratios in the single digits.

Brendan: Right. That's what these kind of costs, in addition to the management that you're getting and the diversification of owning thousands of bonds as opposed to one single one, go to cover, whereas until now, you may not even know all of the costs associated with trading an individual bond. So for most people, I think they want to go the route of owning the diversified bond fund as opposed to individual bonds just because of the costs involved. You have to be a pretty big investor just to even think about owning individual bonds.

Tom Mullooly: And being diversified.

Brendan: Yeah, exactly. You're not going to be able to put together a portfolio of diversified bond exposure with an average amount of money. That's just not happening.

Tom Mullooly: It's very hard to do. So something else that we saw in the news today. California is set to require by 2020 in new home constructions, they're going to require solar panels. Required. It's going to add almost $10,000 to the cost of an average home. The average home in California, $541,000.

Brendan: And tough to project, but is there a cost savings over time? Is it like the upfront layout to save money over time?

Tom Mullooly: I think we've been told through advertising that we can sell our solar energy that we've stored up, right?

Brendan: I have no idea, so I would just be making stuff up if I could tell you about cost benefits of solar. I think probably what people dislike more is being told what they have to do with their personal property. And I am not totally against regulations and rules; I'm not a complete free marketer, but I do kind of have a problem with a state telling people what type of power they can run into their house or can't.

Tom Mullooly: A free market example, if we were to bring this down to grassroots level, after school I would go around the corner to the playground with Barry Bocklett and his brother and my brother, and we would just play baseball all afternoon. No one used the field, no one used the backstop. It was ours. We played it, and we played it until we were tired or it was time for dinner. Free market. And we made up the rules as we went along. Government getting involved? Little League. There was a rule for everything, and I mean I was a Little League coach, I was Little League president, and then I got on the district commission, and we sat through meetings and all they wanted to do was come up with new legislation, new rules. So I think this whole idea of requiring new construction homes to have solar paneling? What? I'm building my own home.

Brendan: I think a requirement is probably too strong, but I would be okay with a subsidy to encourage it.

Tom Mullooly: Sure. Give us tax credit. Give us something.

Brendan: I'm fine with that level of government involvement, but I think that telling people that they have to do something is probably crossing the line. So we saw another one in the Wall Street Journal that was about elder financial fraud. It's sad stuff. I hate hearing about it.

Tom Mullooly: It's sad in the sense that we have to talk about this. It's sad what we hear, and we see and hear ... We lived through some of these horror stories here at the office where people come in and they tell us these things that have happened to them or to members of their family, and it paints investment advisors, stock brokers, people in our industry in a bad light. But it's also difficult to see that we, we still aren't doing a good job of this. There was a story in the Wall Street Journal, elder financial fraud is worse than we thought, and then they talked about here are some ideas of what they can do about it. They talk about a survey that they did where they asked respondents several questions about whether they had been victimized by financial fraud. Have you been victimized?

Brendan: Everybody wants to be…

Tom Mullooly: I'm a victim, we're all victims. And so this is the part that really started making my hair stand up. They said they wanted to know if you've been victimized by financial fraud within the last five years. And by victimized, they meant by did you invest money after a meeting that offered a free meal, like one of these free chicken dinner seminars? Did you invest after receiving a cold call from area code 2-1-2 or 2-1-3 or 2-1-4? Or did you invest in penny stocks or an investment that guaranteed daily returns of more than 10 percent, like marijuana stocks, Bitcoin, things like that? Of all of the respondents, they said only three percent had invested after being given a free meal. That is a lie. That is a lie because those people will continue to get mail from that broker or advisor until they die, and then they'll come in. Very few acted after getting a phone call, things like that. But they said that about eight percent of the over-50 group admitted that they had fallen prey to at least one of these activities over the last five years.

But the thing that really kind of leads into another discussion is -- and we just did a video about this as well -- is that half of all adults in their 80's today either have dementia or some form of impairment. And it's something that ... We went through it with a client that we've had, that I've been working with for over 20 years. And you start to see the decline in their cognitive skills, and then we found out that he was getting royally scammed out of a lot of money. It's a tough thing as the advisor to see this happening to your clients you've been working with for a long time.

Brendan: I also think that the different circumstances that they outlined in a survey of sorts ... So we get people get sold crummy investments through those methods all the time. People go to chicken dinner seminars and buy annuities when they're 40, that's fine. It doesn't only happen to seniors. Are we worried about them, too? We probably should be, but again, what are we doing about it? How much do we want to regulate this? Are people going to feel like their liberties are being infringed upon if we tell them they can't buy variable annuities after eating a chicken dinner? I mean, it's probably not in their best interests, but if somebody is dead set on doing it I can try to talk them out of it, tell them why it's a bad idea. But ultimately if they want to do it, it's their own money.

Tom Mullooly: If they want to do it, they're going to do it.

Brendan: I don't know. It's a tricky situation where it would mean, what, more regulation on seniors? That's a group that's even tougher to sell on more regulation than anybody else.

Tom Mullooly: We're back to Little League.

Brendan: Right.

Tom Mullooly: So how many rules do we have to have?

Brendan: Right. It's just a shame because it ultimately boils down to people in our industry doing the right thing or not, but that's our belief system. We believe in one version of the right thing, and other people believe in theirs. Some people think that chicken dinner variable annuity sales are like doing a favor for people because that's what they sell and they believe that stuff. I don't know. I can tell them that they're wrong, but they don't believe me. It's tough to get somebody to believe something when they're incentivized to do it. I'm paraphrasing that quote. That gets turned around all the time, but they're being paid to do these things so they're going to keep doing them.

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Brendan: Another one from the Wall Street Journal about pension funds. Pension funds still making promises they probably can't keep, and they're centered around return expectations for a lot of pension funds.

Tom Mullooly: Understand that if a pension fund is aiming to return eight percent, and they come up when the dust settles and they've only earned four and a half percent, someone's got to make up that shortfall because now they don't have enough money to pay out each month to Mr. and Mrs. Retiree.

Brendan: And this is a problem that we see not just in pensions, but individuals do this, too, and people building a financial plan. You need to have some kind of return assumptions, so again, like a forecast about the future that you have to make, just make are realistic one because in your scenario it's a pension fund, so this could affect hundreds and thousands of people's retirements because they're expecting a dollar amount in retirement forever from the pension. But even just in a financial plan, if you have return expectations that are too high and they don't happen, then what does that mean for that person? That means that they're out of money. You cannot have that.

So our belief -- and I wish that pensions would take the same approach, I think a lot of people agree -- is that they should project for lower than average returns and be pleasantly surprised with the surplus they have when things work out better, not the opposite. So this is pension plans expecting median annual returns of seven and a quarter percent over the next decade?

Tom Mullooly: That's completely, in my opinion, that is completely too high.

Brendan: I mean, just looking from a standpoint of where we are in market cycle and valuations, I haven't seen many people project stocks, U.S. stocks, over the next decade for much more than five or six percent I think is the highest that I've seen from rational thinkers who I respect. And bonds are basically based off of the starting yield; so what, like two and a half percent on the aggregate bond index right now? So if you're getting six percent from stocks, let's say on the high end, two and a half percent from bonds, then where is this extra performance coming from?

Tom Mullooly: You have a 60-40 portfolio, even that's aggressive for a pension fund. You're talking about four percent.

Brendan: But this is why a lot of pension funds, I think, have gotten into trouble doing crazy things like private equity and these more-

Tom Mullooly: And now they're buying commodities.

Brendan: Yeah, these more esoteric asset classes like lumber and stuff. It's like maybe Swenson over at Yale has done well with that, but the average, the median pension fund is probably losing their shirt trying to be David Swenson when they would be fine in index portfolios and just lowering their return assumptions. But that's such a tough thing to ask a panel of investment experts to do because it's basically saying you don't need to pay us as much as you do.

Tom Mullooly: Right. We're starting to see these pension plans get into private equity deals. Uber, perfect example.

Brendan: Some of them work out great and some of them don't.

Tom Mullooly: A lot of them don't. So what do you do when some of these deals wind up a big zero?

Brendan: What they're trying to do now is they see these return assumptions that they need to hit and they're trying to hit home run balls, and we discourage ... Again, to relate this back to individuals, is it's not apples to apples, but it's close. This is like the person who is coming short in terms of putting together a retirement income projection and wants to take more risk in stocks to try to fix it rather than trying to work longer or save more money. It's like we know what can actually fix the problem, but it's the difficult ones. Everyone wants to do the easy ones. It's like, oh, we'll just make more money. Oh great, we'll just go out to the money tree and pick it right off of there. It's not going to happen.

Tom Mullooly: We had a conversation today about a client who will remain nameless ... Actually, this person's not even a client, who we have talked to them about being conservative, being conservative, being conservative, and this person emailed us with a list of ETFs, literally just like a list of last year's top performing ETFs. Nothing about them, just the symbols, and we knew the symbols because we've seen them, and some of them we've owned. But it just struck me as when that person left our office awhile back, I thought he understood that we think you ought to be really conservative. You're at the age where you shouldn't be taking a whole lot of risk, and everything that he gave us was high flying, 100 percent risk oriented.

Brendan: It's easy to do looking out the rear view mirror and seeing a year like 2017 where you literally could have owned almost anything and made money. So let's just go back, cherry pick the most risky stuff that did great last year, and forget that risk exists.

Tom Mullooly: Fire up the flux capacitor at work again. Bring us back.

Brendan: Yeah, Rear View Capital.

Tom Mullooly: Yeah. I have something else that's been kind of bugging me. For the last couple of weeks, Tiger is back on the golf tour and he's playing really well. He hasn't won anything yet, but it seems like he gets to the fourth tee and he's popping ibuprofen, like Advil or Motrin or something like that. And he's popping it consistently through his round. And his doctor told him take the ibuprofen, it's going to help you. By comparison, Freddie Couples -- remember him? -- Freddie Couples basically lived on ibuprofen the same way, and he gave it up, and so he hasn't done as well ...

There was a story about this in the Wall Street Journal and one of the medical professionals that they quoted said you really shouldn't be taking this kind of stuff. Ibuprofen is really ... If you take that a lot, you can open yourself up to kidney damage and a lot of other problems with internal organs. But this doctor said you have to learn to respect the pain because it's telling you to stop. And he said the benefits from ibuprofen can be ... We're going to get in trouble for saying this, but the benefits of ibuprofen can be, you can get the same kind of benefits from eating a banana.

Brendan: That's interesting. I more like the message, though, of what he's saying, like if you're feeling this pain over and over, it's your body telling you to stop.

Tom Mullooly: You shouldn't be doing this.

Brendan: Just to equate everything back to investments like I always do, if you have a portfolio and the market is pulling back its regular, routine five percent drop and you literally cannot stand it, like you're freaking out, that's your portfolio telling you that you are taking too much risk, that you can't handle it. And regardless of what you feel when the market is going up, I think that that is sending you a message that you have too much going on in your portfolio for what you can handle. If you're watching every tick of the stock market with your heart racing because it's like a high-stakes game for you, I think you need to chill out and a good way to maybe do that is to just have a little bit less going on in your portfolio.

Tom Mullooly: Out of curiosity, what's on your summer reading list?

Brendan: Right now I am reading Guns, Germs, and Steel, by Jared Diamond. It's a ...

Tom Mullooly: Wait a minute. He writes about baseball.

Brendan: Does he?

Tom Mullooly: Is this the same guy?

Brendan: It may or may not be. I am not sure.

Tom Mullooly: Does he write for the Wall Street Journal?

Brendan: Casey said the same thing to me earlier today, and I was clueless. I had seen a bunch of people reading this. It's kind of ... I guess Jared Diamond had influenced the author of Sapiens, whose name I'm drawing a blank on. But anyway, kind of similar books in the sense that's it's just like human evolutionary history, so pretty interesting. I've got a couple more teed up after that, but that's what I'm in now and that's a pretty big one, so I'm kind of working my way though that.

Tom Mullooly: Good. So I'm going to be finishing up the Ed Latimore book.

Brendan: Nice. Good Twitter follow if you're on there.

Tom Mullooly: Not Caring What Other People Think is a Super Power.

Brendan: It is.

Tom Mullooly: It's an excellent book; I'm about halfway through that. I recently finished the Jocko book.

Brendan: Nice. Another good Twitter follow and fellow podcaster. If you're listening to other podcasts, Jocko podcast is very good.

Tom Mullooly: Well worth your time. Also just landed on my desk is the Annie Duke book, Thinking in Bets.

Brendan: Nice. I think I'm going to have to borrow that one from you after you are done with it. I've heard very good things about that.

Tom Mullooly: Well that wraps up episode 212 in New York City. Again, our next episode, 2-1-3, will be from Los Angeles, and then Dallas, 2-1-4, and Philly 2-1-5. Thanks for listening to the Mullooly Asset Management podcast. See you next time.