Ep. 218: Junk Bonds, Probabilities, Netflix Dominance - Transcript

Tom Mullooly: Welcome to the Mullooly Asset Management Podcast. This is episode number 218 as we swing through the Great Lakes Region. 218 area code is for Cleveland, Ohio. Along for the ride today, I am Tom Mullooly, and with me ...

Brendan M.: Brendan Mullooly. Let's get into it.

Tom Mullooly: Let's get going. Some of the things that we've been kicking around in the office here, some of the topics that we've seen in the news recently, for starters, junk debt, junk bonds outdoing some of its peers. This was an article in The Wall Street Journal.

Brendan M.: Right. Junk bonds have performed better than things like Treasuries this year or even the more investment-grade corporates, so they had an article about that. I love the adjectives that they used to describe bad years for bonds. We're talking about an aggregate index being off 2 or 3%, like high-quality US bonds here. Forgetting the terminology they used, but it was obviously supposed to be attention-grabbing.

Tom Mullooly: I think the thing that a lot of people misunderstand is, when you're looking at bonds, yes, there's different classifications of bonds. Of course, there's municipal, and there's treasury and, of course, with all of these, there's long, intermediate, and short-term durations, but junk bonds are a class of bonds different from everything else because, really, they display more qualities that you'll find in a stock or equity-like characteristics than you'll find in a traditional bond like a Treasury bond or some other investment-grade corporate bond. A lot of times, we wind up ... When we're talking to clients, and they bring up the topic of junk bonds, we tell them, "Hey, for all the risk that you're taking with junk bonds, just buy the stock. You might be better off."

Brendan M.: Look, and that's just our philosophy. We rely on our bonds in portfolios to be a hedge against the stocks, so it doesn't make sense in that context, but that doesn't mean that nobody in the world should have money in junk bonds. I mean if that's fitting into whatever they're trying to accomplish, that's fine, just not our preferred take on things.

One of the, I guess, points they were making in this article is that high-yield ends up being more tied to the US economy and, therefore, the market too because these are, I guess, not usually large multinationals so they don't have some of the headwinds that bigger companies have been facing this year. We've seen the same divergence in small and large stocks where the US economy seems to be doing pretty well, and maybe the story has changed. Obviously, jury's out. We only view the economy through hindsight. You only know you're in a recession or a depression after six months or a year, so it's not as if we can foresee this, but Europe and some of the emerging markets don't look as strong as US economies now, so they kind of presented that as a case for maybe why this divergence is occurring.

If you own bonds to hedge risks from the stock end of your portfolio, not really sure that high-yield junk bonds are going to do that for you. They haven't historically. I'm not comfortable saying that they will in the future either.

Tom Mullooly: For a lot of our clients, we look at the bond portion of their portfolio as something that is going to provide some kind of hedge or protection for what could happen in the stock market and also act as kind of a bubble wrap for what's going on on the equity side. It's just our opinion that junk bonds don't really give you the bumper that you're expecting from a bond. It's going to behave a lot more like a stock than anything else that we can find in the bond universe, unless you're talking about some kind of structured product.

Brendan M.: Well, I mean I think the same case could be made for people that substitute utilities and REITs for bonds. It's the same thing. That's not much different than owning junk bonds. It's not bonds. They're going to go down when the market goes down, or dividend stocks, too, get subbed in for bonds sometimes by people, depending on their beliefs, and I don't think that that's a good idea either.

Tom Mullooly: Yeah. Well, another article that we picked up on that we've talked here around the conference table in our meetings is chances of a recession in the United States are creeping higher. You just brought this up that we're not going to know if we're in a recession or not until after the fact.

Brendan M.: Right. One of the interesting things about this article was that ... so they noted that ... I think this was a Spanish bank and their risk model or whatever. I mean all banks are using these kind of things because they think forecasting is possible.

Tom Mullooly: Well, all models work, right?

Brendan M.: Well, I mean it depends. What this actually said is that the chance, from this model's output, said roughly 5% chance of a recession in January, and now it's up to 16%, which the last time it was at this level was in the beginning of 2016. The model spiked to this level, which just ... I know that there are ... They talked about multiple inputs that feed into this thing, but it's largely just going to be rear-view-based on what has happened in the stock market. The last time the stock market went down 10 or 15%, this thing spiked, and that's exactly what happened after January of this year when we got the low reading of 5, and now we're up to 16. Again, I think you need to keep in context what they're saying. They're not saying that ... The chances are creeping higher, sure, but they're saying that there's an 84% chance that we're not headed into a recession.

Tom Mullooly: We're not ... Right.

Brendan M.: I saw something similar from Cliff Asness from AQR, this morning, was sharing some thoughts on that post that was going around yesterday about UBS ran like 10,000 simulations on the World Cup that said Germany would win. If you actually read what the UBS thing said, it said that Germany had a 24% chance of winning.

Tom Mullooly: 24%, yeah.

Brendan M.: That may have been, I think it was, the highest percent chance that they gave to any of the teams, but they didn't say binary-

Tom Mullooly: They were going to win.

Brendan M.: Binary yes, no, win, lose-

Tom Mullooly: On, off. Right.

Brendan M.: ... Germany has to win. That's not what probabilities are, and I think you're always going to get headlines that slap something catchy on there so that people will click because people want binary. They want black and white, yes or no, win or lose.

Tom Mullooly: We want the black box. Yeah. We want yes or no, on or off.

Brendan M.: Right, but that's not-

Tom Mullooly: We want to know this.

Brendan M.: That's not how ... There are very few things in the world that work that way, I guess, is what I'm saying, so not sure if I buy what ... I don't know what feeds into this model, but I more took it as a chance to bring up ... That's like a pet peeve of mine, the probabilities things and how people ... Somebody has said this recently, and I just continue using it all the time now is that, if somebody gives you a probability above 50%, you round it to 100, and if it's below 50%, you round it to zero.

Tom Mullooly: Below 50, it's zero. Right.

Brendan M.: We force binary readings on non-binary-

Tom Mullooly: Events, right?

Brendan M.: Right. I think that's our fault, not the model's fault, so we could say like-

Tom Mullooly: That's our brain finishing someone else's sentence for them.

Brendan M.: Yeah. I don't think that the models are at fault here. I think that's us being stupid.

Tom Mullooly: In a sarcastic way, finish the sentence for me, Brendan. What inning are we in?

Brendan M.: Yeah, exactly. I mean we can go back and tell you what inning we're in a year from now. You know?

Tom Mullooly: Yeah. We'll know. June of 2018, we were definitely in the fill-in-the-blank inning. We just don't know.

Brendan M.: We don't, and that's the honest answer. It's unsatisfying, and I'm okay with that.

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Tom Mullooly: I heard someone say that 37 friends of this guy that we know have his Netflix password, and so everybody's using the same account. What is going on with AT&T, and Time Warner, and all these old media companies that are trying to catch up to what Netflix is doing?

Brendan M.: There was a pretty good article in The Wall Street Journal this week, and it was ... The point they were making was that these medias companies like you just alluded to are kind of teaming up to try to combat things like Netflix, and Amazon has their video, and Apple has been signing people to put out video content.

Tom Mullooly: Yahoo bought GeoCities, so ...

Brendan M.: Yeah. The point that this article made was kind of that they can team up all they want, but in terms of getting investors' money, people are still going to give to the newer companies because, for whatever reason, we view them as tech companies, so earnings don't matter, and it's just the idea of this growth and the future where Amazon and Netflix are overlords who enslave all of us and own everything. I'm not ... I guess maybe I am mocking that a little bit, but it doesn't seem that implausible, but people are buying into this, obviously, because they keep buying the stock, but the older media companies, regardless of whether they stay how they are now or they team up to try to reinvent themselves, are still going to be treated like media companies, so things like earnings matter for them, so they can't get the capital and invest so aggressively in the way that some of these newer companies like Netflix or Amazon are able to. I guess I agree with that. I mean it makes sense to me.

Tom Mullooly: I look at some of these old-line companies that got into the cable business 30 years ago, and some of them are just now starting to retire debt that actually put cables, wires, in the ground or on telephone poles.

Brendan M.: Big cost outlay-

Tom Mullooly: Huge.

Brendan M.: ... to recoup, basically, like an annuity over time to get their costs back, which is ... A lot of these companies have a lot of debt. That's right?

Tom Mullooly: They're upside-down. They're over-leveraged, but the concept in the '80s was lever up as much as we can, raise all the money so that we can put the ... lay the cable, lay the fiber.

Brendan M.: Yeah. It's a printing press. We'll just set it up and then print the money over time.

Tom Mullooly: Right. There was actually deals in the 1980s where ... There was a company out of Denver called Jones Intercable, and if you placed money, you put some of your clients' money into one of their deals, they would fly you out to Denver for the weekend and treat you like a king. It was kind of scary, but those kind of projects just showed you the extent of money that they had to raise to finish wiring the last mile, which is still the golden goose, the thing that everybody wants.

Brendan M.: They have to be so pissed off because the way that these new streaming-type companies are working is that they're using the infrastructure that these older companies laid out to deliver their product that's cannibalizing their business, and if they were to do something about it like raise prices on internet or do anything else, how incredibly unpopular would that be?

Tom Mullooly: Yeah.

Brendan M.: It's like you take an unpopular company like whoever is your internet and cable provider, nobody likes them anyway ... I literally just got off the phone with my company yesterday after seeing my rate go up, and I called in and said I was going to cancel, so they gave me a new lower rate, and that's what we do. We do this charade every year, and I hate it. It's ridiculous.

Tom Mullooly: I can only imagine what the management of these old-line cable companies were thinking when they saw a satellite go up in the sky, these companies like Dish and DirecTV, like, "They're doing it without wires? Not fair. Not fair." Yet that's how-

Brendan M.: Yeah. I mean streaming companies are just piggybacking off of all of the stuff that they set up. Basically, they're Zuckerberging them, like they're MySpace, and now Facebook has come along, and they're just like, "Oh, crap."

Tom Mullooly: I had heard lots of stories in the late '90s as we were going into the top of the tech bubble, '99, 2000, 2001, where there were stories going around that 80% of the cable, the fiber that had been laid over the last 20 years to deliver high-speed internet and video and all that stuff, was dark, wasn't even being used. I have to believe that's where a company like Amazon says, "Hey, we need to have a lot of servers. We need to have a lot of space, but now we have too much. Hey, we can sell our space."

Basically, what Amazon is doing with Amazon Web Services, I mean that's a stand-alone company or should be a stand-alone company all on its own. They're basically taking that storage space kind of idea, "Hey, we'll just you rent you our extra space because we don't need it yet, and in 20 years we might. Then we'll kick you off or we'll raise your rates," and so you have these storage facilities that are all built on the outside of town, and then as gentrification happens and people move out to the suburbs or outside the city, all of a sudden, the real estate is worth a lot more because people need the space. Amazon was just way ahead of them.

You look at some of these companies like Netflix. Think about all the movies that they stream, how much bandwidth they use. They're using, like you said, all of the cable that was dropped into the ground in 1984, '87, 1990.

Brendan M.: Right, by all these old media companies who are now teaming up together because they realize that they're in trouble.

Tom Mullooly: They need a bailout. Yeah, they still have mountains of debt.

Brendan M.: Right. I don't know. There is just a part of me that ... I have no basis for this, so it's just blind contrarianism, which is probably foolish, but everybody thinks that we're headed to this future where Netflix and Amazon and Apple are the overlords who rule us. We're obviously all missing something that we're not going to see without the benefit of hindsight. How does this play out? Is it really going to be that simple, how we all see it now, Amazon just gives us everything now?

Tom Mullooly: We're not going to know.

Brendan M.: We don't know. I mean-

Tom Mullooly: We're not going to know.

Brendan M.: No, we don't, and there's no way to know, but I think that maybe pumping the brakes on that whole Amazon is going to buy everything and be in every industry seems like a reasonable bet to make.

Tom Mullooly: I'm still holding stock certificates for my horse and buggy companies. They're making a comeback.

Brendan M.: Yeah, right. I'm not going to short Amazon. Ben Carlson and Michael Batnick always joke about-

Tom Mullooly: I don't know.

Brendan M.: ... Michael shorting Amazon back in the day.

Tom Mullooly: Speaking of Amazon, today they announced that they're buying a company, and online pharmacy called PillPack.

Brendan M.: Right, so it's happening. It's done. They're taking over.

Tom Mullooly: They've moved in completely. Yeah.

Brendan M.: Now, this is interesting, though. I mean this is just another area of life that is inconvenient, so if they can deliver this at a similar price point and make it more convenient for me, sure, I'll use Amazon as my pharmacy. Why not?

Tom Mullooly: That's really the point. PillPack is a company that was started four years ago. It was started in 2013, but they're on track for $100 million already in revenue. Pretty good. They announced this this morning while it ... The funny thing is they announced it while Walgreens was having their conference call with analysts to talk about their earnings. Walgreens, which just got added to the Dow Jones Industrial Average, announced that they're raising their dividend and they're buying back $10 billion worth of stock.

Amazon's doing something good in moving into the pharmaceutical delivery business. Walgreens is doing something nice for their stockholders. CVS, not out of the game. They announced last week that they cut a deal with US Postal where US Postal is now going to use their Priority Mail package. Postal Service is going to pick up prescriptions at CVS and deliver them to their clients' homes in a day or two for five bucks.

Brendan M.: I think that the area where they're going to lag, if Amazon's purchase unfolds like it seems it might, is that people who have Prime will probably get the, quote, unquote, free two-day ship, so if there's an additional cost to use the Postal Service, people aren't going to do it, or they might, but it's not as convenient as Amazon. Then also consider the user interface. Isn't CVS the one who prints like four-mile-long receipts still? They're going to give me a good website that I can go to to order my stuff?

Tom Mullooly: Yeah, but I can-

Brendan M.: Or do I still have to call the automated service and talk that way to order my prescription? Because that's-

Tom Mullooly: Well, hold on a second. On those mile-long receipts, you can also fill out a survey, and you can enter to win a prize-

Brendan M.: I can play tic-tac-toe too, if I want.

Tom Mullooly: ... if you drop in your email address, so they can spam you four times a day.

Brendan M.: Right. I don't know. Obviously, they have to do stuff like this to stay on the cutting edge and be one of the biggest pharmacies out there, and I'm sure that that's what they want, so they have to try these things, but I think that it'll be an uphill battle to go against a company like Amazon that already has an easy-to-use website and a contingent of customers who already pay for two-day ship at a flat rate once a year.

Tom Mullooly: Yeah. The story or the number circulating lately is 40% of all online transactions are happening at Amazon, so people are very used to working with them, and I think there's more Prime accounts than people in the United States or something.

Brendan M.: Scott Galloway has some interesting statistic that is, I think, along those lines. I forget what it is exactly.

Tom Mullooly: The whole idea of CVS being able to deliver prescriptions to someone's home, if you're home-bound, that's a real problem getting your prescriptions filled.

Brendan M.: Yeah, absolutely.

Tom Mullooly: Amazon buying an online pharmacy ... Incidentally, both Walgreens and CVS are down 7, 8, 10%, of course not on their earnings, but on the news of someone else getting into their backyard. That's a little troubling for them but, ultimately, who's the winner in all of this? The consumer.

Brendan M.: It's like low fees on investment products like ETFs and mutual funds coming down, like the Vanguard effect, so to speak. Yeah. It helps us. The end-user of the product benefits here, which is great.

Tom Mullooly: Exactly. Yeah. That's really the main underlying theme in all of these events is that these companies are becoming leaner, there's more competition coming into the market, and so everyone's getting a lot more focused on what's happening with the end-consumer. That's really good. That's good for business.

That's going to wrap up our podcast for episode 218, area code 218, Cleveland, so wave to Lebron. Let's wave. Hey, King James.

Brendan M.: The GOAT.

Tom Mullooly: That's right, GOAT, greatest of all time. Episode 219 takes us into northwest Indiana so we can visit the Jackson family, Jackson Five.

Brendan M.: It's also my birthday.

Tom Mullooly: That's right, 2/19. That's right, so that's northwestern Indiana. Thanks for listening, and we will catch you on the next one.