Ep. 231: Back Into the Market, Tax Loss Selling, & What is Smart Beta? - Transcript

Tim Mullooly: Welcome back to the Mullooly Asset Management Podcast. This is episode number 231. This is Tim Mullooly filling in for Tom this week. Brendan is here with me as well. The first article that we wanted to talk about was written by Ben Carlson and it deals with the psychology of sitting in cash. Bren, you want to break it down for us?

Brendan: Ben is one of the more prolific bloggers that are out there. So he's writing multiple posts I think maybe four or five a week normally. And this one he was writing about the idea of going to cash with your investments, whether it be because you think things have become too extended and you're going to wait for a pullback or because you're nervous. I mean however you get there, once you're in cash, what do you do then?

Tim Mullooly: And it's timely because obviously over the last couple weeks the market has pulled back and then as of this recording, the market at least for the time being has seemed to at least stop going down. And today it's up, but that brings into the question when is the right time to get back into the market after you've made the decision to get out of the market?

Brendan: Yeah. And it's going to be obviously dependent on what you're trying to accomplish. But Ben was kind of getting at the idea that cash gives you optionality, which is true. I think as an aside you should always have money, liquid ready to go outside of your market investments. But within the market it gives you optionality too to kind of "swing at a fat pitch." Buffett talks about being patient and waiting for your pitch and these opportunities. But that means being able to identify them which is really tough.

So if you have a bunch of money in cash, I mean how do you recognize that it's an opportunity? If the market's falling, you're probably scared. And so one of the ideas that Ben talks about is that corrections or bear markets don't make it any easier to pull the trigger. So like I just said, while the market is falling, in theory it sounds like, "Oh yeah, stocks are on sale. I'll jump in there and buy at a discount." But in reality it becomes really difficult to actually act upon that and pull the trigger in the heat of the moment.

Tim Mullooly: You hear about that like, "Oh, they're on sale." And people always say that while the market's going up, but you never hear people say that when it's going down. Everyone's like, "Oh, is this the start of something else? Is this the start of another recession or another 2008?" Someone gets really worried.

Brendan: It always could be, and there are always scary factors that people begin discussing when the market's pulling back, trying to explain what's happening. And some of them obviously are the same old stories all the time and they're kind of ridiculous. But other times these are perfectly reasonable things that people are discussing. So I don't know, it takes a little bit of humility I think to just recognize that you probably won't be chomping at the bit to put your money to work when the market has dropped 20%, 30% and you've been sitting on cash. I think it almost one of the analogies Ben uses in this post is cash becomes like a warm blanket on a cold Saturday morning when you don't want to get out of bed.

It's just like, yeah, I could put my money to work, but this is kind of comfortable. And then you blink and five years have gone and your money still isn't working for you. It's sitting in cash. I mean, you may have nailed it in the short term. Maybe you did sidestep some damage, but if you don't get back in at some point in the future, I think it's going to be something that you look at in hindsight as if not a mistake then you get rid of all the benefit that you had of sidestepping. I mean whether anybody can effectively do that.

Tim Mullooly: Right. I think that was another point too. It's in this case, you have to nail the market timing aspect of it twice and just doing it once is hard enough, doing it twice, meaning you have to nail it on the way down and then you have to nail it on the way back in assuming you want to put your money back in.

Brendan: You've got to be so flexible like mentally to do that because I think that the type of person who correctly nails a market top or calls a decline, is probably calling for that pretty regularly. So I think just to generalize, those people are probably like pretty pessimistic. And then to be able to then pivot somewhere near the bottom and become an optimist and then call the reversal of everything getting better. I think not many people are like Dr Jekyll and Mr Hyde like that where they can just like become a totally different person with a different disposition. I don't know, maybe it depends on what kind of research they're doing. I don't know, but I would bet that it's not going to be the case. It's going to be pretty difficult for the same person to make those correct calls on both ends.

Tim Mullooly: Yeah. And I mean in this specific instance, it's hard to avoid whips on yourself when getting out and getting back in because if someone in the midst of this latest pull back like a month ago, they could be wanting to get back in now only weeks later. It's not like they were sitting on the sidelines for four or five years. That's a matter of it hasn't even been a month, and sentiment has started to shift back away from the pessimistic side of things. You could want to get your money back in, but it's only been a couple of weeks. It might feel kind of foolish.

Brendan: I think too, let's say you go to cash because you think things have been too good for too long and that were due or whatever. If you go to cash, not in the environment of like, oh the market's pulling back, now I'm going to do this. You just do it because you are dead set that things are overvalued or extended and the market's going to go down at some point in the future. What if it never does? I mean it will eventually, but you get what I'm saying? I think Ben talked about in the post, what if in 2014 you want to cash after a lights out year where the market was up something like 30%, 2013.

Tim Mullooly: You couldn't think it can continue from there, actually it was crazy.

Brendan: Yeah, exactly. So okay, I'm going to go to cash because obviously we're due for some kind of a correction. I mean, you have had some 5% and 10% moves there, but you haven't had a dramatic opportunity or a green light so to speak, to say, “Wow, things just got cheap.” Like you were right, this was so overvalued. So maybe since the end of 2013, early 2014, you flipped a cash and you've just been sitting there since. There's been great returns out there for you that I mean depending on who you are maybe you need those for your retirement one day. You've forgone those, you're waiting in cash now and it becomes harder and harder the longer you're sitting in cash, you come up with more and more reasons for why this is defensible and you become convinced that it's the right thing to do and you wait longer and longer and you'd never get back in.

Tim Mullooly: I guess the mentality for those people like after a 30% year, just because the market goes up 30% in one year doesn't mean that it needs to correct itself 30% for you to feel okay with the market again. Like you said there were some 5% and 10% pullbacks along the way from 2013 until now, but it wasn't that big 30% move in the downside that maybe people like that we're expecting.

Brendan: Nice segue though because speaking of 5% and 10% corrections in the market, Charlie Bilello from Pension Partners had some pretty good data. Charlie is always one to contextualize things, well in my opinion. And he posted a chart recently that had all of the S&P 500 corrections greater than 5% from the March, 2009 lows.

Tim Mullooly: He said it started out by saying that the S&P has given back 11%, pretty much all of its gains for this year. And he was saying how it's the largest decline since earlier this year, which-

Brendan: It was almost identical if that was the bottom, whatever this was like a week, a week and a half ago. I mean, it was almost identical to the January, February move that we saw earlier this year and not too different in terms of how many days it happened over either which, which is kind of interesting. Just a really swift 11.5% drawdown. These things are never precise but pretty regular correction, but it never seems that way.

Tim Mullooly: He outlines the number of corrections or 5% moves down greater in the market over the last 10 or so years. And the average number of days that it's lasted is about 42. The median now is around 26, so give or take a month for these corrections. And the average decline is about 9%, again with the median somewhere in between 8.5%, 9%.

Brendan: Pretty much every year on this chart too has one or two instances. I think the only one missing here is 2017. That was pretty abnormal. We hit 2009, I mean even more instances 2010, three, 2011 three, 2012-

Tim Mullooly: That great year that we were just talking about in 2013 had one of them 33 days, the market went down 7.5%.

Brendan: That was like the taper tantrum people were worried about. The fed and interest rates and the market sold off along with bonds. So then in the midst of a gangbusters year in the market, I mean that's the best year in recent memory, so it's not in the last year.

Tim Mullooly: So you sold because the market was going down 7.5% during that month and then never got back in, even just to finish out that year, you missed quite a bit. So kind of wrapping those two posts together.

Brendan: Yeah, I think they pair nicely. But it just shows the regularity that these things happen with. And obviously a lot of people would say, “Okay, so this is showing all of the ones that have basically been nothing since 2008.” So yeah, I mean this doesn't cover the one that was the one in recent memory. But this is to say that there are plenty of opportunities. I'm sure we could go down this list and start ticking off the reasons either in hindsight or in the moment that we came up with for why the market was selling off.

But there are always reasons to get scared out of stocks or your investment plan or your diversified portfolio. And more often than not they are just that. They're just opportunities to be scared out of something that is otherwise reasonable and set to accomplish some kind of rate of return that's going to support your lifestyle and your goals over the long term. And that's not to dismiss how scary this could be, but it's a pretty regular occurrence even though it never feels regular or normal when it's happening.

Tim Mullooly: Yeah. And it's hard to identify. Charlie also talked about different kinds of bounces.

Brendan: Yeah, like at the end of these pull backs and there were a couple of different ones, and what they signified for the market like a dead cat bounce or the holy grail he called it, which was a bounce at the end of 2009 and then the market just comes back roaring from there. I mean, he finished the article asking, “Well, which one of these bounces applies now or will be the next one?” And we know it's impossible. Maybe a good way to approach it is just trying to come up with a blend of investments or strategies that works for you.

So obviously if you don't need to be not being 100% in stocks or if you are the kind of person who is prone to freak out during during corrections like this, maybe coming up with some kind of like a rules based tactical model that's going to use signal to tell you with a piece of your portfolio that you are allowed to get defensive. Because I think if you're going to do this in the heat of the moment, fly by the seat of your pants, got calls. I think you have plenty of opportunity to be psyched out by the market.

And the kind of I think like mental scarring that can come from getting freaked out during a 10% correction, selling all your stuff, realizing it was a mistake, getting back in, getting freaked out again because inevitably the market is going to drop at some point again. You're just running through this cycle a couple of times I think can freak some people out enough to the extent that they don't invest or just have no idea what they're doing whatsoever. I don't know you can learn from doing things like that, but it can also freak you out.

Tim Mullooly: I think it's tough though for some people as individuals because that requires an extreme amount of self-awareness and also just willpower, set rules for yourself and not just manually override them when things go bad. So for me that just points towards one of the benefits of working with another person. You kind of take the power out of your hand and in a sense it's-

Brendan: We're all really good at finding the flaws or mistakes that other people did. So definitely that's one of the biggest benefits of working with an advisor. But an advisor can easily become a scapegoat and there can be finger pointing between a client and advisor if communication isn't good. And so just having the right expectations when you're working with another person even. I think I agree obviously in a self-serving fashion that I think one of the best things an advisor can do for a client is being this behavioral mechanism that doesn't let you rip up the script on your long term investment plan.

Tim Mullooly: Investment roadblock.

Brendan: Yeah, exactly. But there are still ways around that. It's not like you can always fire your advisor and find someone who will let you dictate the game. And ultimately you can do what you want with your own money.

DISCLAIMER: Tom Mullooly is an investment advisor representative with Mullooly Asset Management. All opinions expressed by Tom and his podcast guests are solely their own opinions and do not necessarily reflect the opinions of Mullooly Asset Management. This podcast is for informational purposes only and should not be relied upon as a basis for investment decisions. Clients of Mullooly Asset Management may maintain positions, insecurities discussed in this podcast.

Brendan: Yeah, I would always say that being more in tune with your own emotions is more important than being like the biggest brainiac when it comes to like which strategy to use or tactics for investing. I think if you have the right emotional makeup to do something, stick with it. Recognize that it's going to go into and out of favor and be fun and terrible and difficult and all of these things all in between. If you can recognize that and become mostly okay with everything that's going to happen, I think you're going to outperform people even that are super-duper smart.

Tim Mullooly: Yep. Kind of switching gears here a little bit, still on the emotional side of things for people. Why do you think when it comes to taking tax losses with their investments people always do that in December? There was a good article in the Wall Street Journal about why investors shouldn't wait until December to take their tax losses.

Brendan: So this was from Meir Statman in the Journal. I mean obviously you have more, well maybe not obviously. I guess if the market pulls back in January or February and you have the opportunity to, and it makes sense, you have a taxable account and you have some losses in that you can recognize and maybe pair with some gains. You can tax lost harvest in February or January for the calendar year. You have 12 months to do it, but for whatever reason towards the end of the year it does come more to the top of the mind.

Tim Mullooly: Do you think that it's because there's, I mean obviously the deadline is December 31st, but some people might put in emotional anchor when they buy a position. And they give themselves at least till the end of the year, may like, "I'll wait till the end of the year if I still have a loss then, then I'll take the loss."

Brendan: We all hate recognizing losses. This is like classic loss aversion.

Tim Mullooly: No one wants to admit that they were wrong or they've failed, they picked the wrong stock. But picking stocks is hard, you're going to pick the wrong stocks. But I guess that deadline they want to wait until the very last second to realize that loss because, hey, you never know, it could come back. I'm down 20%, but it could come back.

Brendan: They still like the idea of being able to break even as always one that comes up with investments. It's like, well, if I can just get back to even then I'll move on and we'll forget about it because the pain of recognizing a loss is basically admitting a mistake or that things just didn't work out in the short term. I mean, a lot of factors can influence that, it doesn't have to be a mistake. But in our minds it's like, "Wow, I screwed up. This was a mistake." And being able to avoid that or kick the can maybe until like November, December is appealing.

Tim Mullooly: And then that has nothing to do with it. Kind of getting back to like gaming the system you could be like, "Well I'll wait until the end of December to see where it's at." And then you kind of kicked the can for a week or two and then like, "Oh well it's January so I'll wait until the end of this year." You've given yourself a longer and longer-

Brendan: Yeah, a loss is a loss. If you have a loss on the last trading day of the year, you're going to open with a loss the next trading day of the year. So you could recognize your loss whenever you want and still use it either to offset a small amount of taxable income or gains and other investments. So to give some credit to the people, I guess if you wait until December but then go through with it. Assuming that tax loss harvesting makes sense for what you're trying to do, if you actually go through with it, I mean it's better than not doing it at all. I think being conscious of taxes and taking advantage of something that didn't work out in your favor is smart. So maybe the December people, it's better than somebody who just never sells because they're still at a loss.

Tim Mullooly: It doesn't really matter when during the year, but if you just have a taxable account and say you have some positions that you've held for years and years and they've done really well, but now you're kind of in this pickle where you have these great investments but you have all of these gains.

Brendan: It's like I have an account with $100,000 in it, but $50,000 of it is capital gains and maybe I need money for something, but I don't want to sell any of these investments because I have extra taxes to pay because of it. It's not as accessible as $100,000 sitting in a bank account. So you can be smart about that and maybe pair it together to periodically, shave some gains off of other investments with losses that you're taking. And other ones you can be smart about setting yourself up to have cash available that isn't going to totally crush you on taxes when the time comes.

Tim Mullooly: So I guess just listeners keep in mind that doesn't need to happen in December. If you have a loss and it's March and you want to take some of that-

Brendan: If it makes sense, do it.

Tim Mullooly: I feel like some people might think that you need to wait until December.

Brendan: Yeah, this is time.

Tim Mullooly: It's almost the opposite, you don't have to.

Brendan: Right. It's situationally dependent it's going to make sense now or next month or Summer.

Tim Mullooly: I mean, we've said it in conversations here the market doesn't know what month it is. Your stocks don't know what month it is, so they don't perform any differently.

Brendan: Now that's a good point. That's along the lines of the famous, like the stock doesn't know that you own it. I think that was like, right. Jesse Livermore or something. But that makes perfect sense to me. Nike the company doesn't necessarily care that it's November. It doesn't perform differently because of that. So for you to say I'm going to wait for a specific time of year to sell, don't need to do it.

Tim Mullooly: So I think we had one more that we wanted to touch on this episode.

Brendan: Yeah. So the last one was from the Financial Times and it was talking about how ... The title was the Smart Beta Growth Engine Sputters as Investments Question Strategy and-

Tim Mullooly: A lot of questionable words in that title.

Brendan: Yeah, I mean they're all going to slap a headline on there. It was click baity and I was taking the bait so I decided to read it. But they were talking about how last year Smart Beta Funds, so big big blanket term there. Smart Beta Funds took in like $92 billion in 2017, and this year they've only so far taken in about $56 billion. So they're on track to not take in quite as much as they did last year.

Tim Mullooly: But still close relatively.

Brendan: Yeah. I mean depending on the end of the year, maybe they do get there. But I'm not sure that Sputters is-

Tim Mullooly: Yeah, that's what I was going to say. It depends on what you define as sputtering. I would say some other areas of the market were sputtering harder.

Brendan: In terms of flows, this is the point that Eric Balchunas brought up from Bloomberg. He said that active mutual funds, I mean, and this is probably the case last year to have seen outflows again of over $100 billion this year. So relatively to last year, maybe Smart Beta funds are not taking in as much in terms of dollars this year, but relative to what many would compare them to, which is like the active sphere of mutual funds, they're crushing it obviously. I mean huge gap in terms of flows.

Tim Mullooly: So I guess it's a relative sputter. The other thing you said, it's kind of a blanket term, what is Smart Beta? And I've seen this conversation on Twitter as well.

Brendan: They were referring to it as if it's like an asset class or something. But Smart Beta could mean a ton of ... We could be talking about US large cap value stocks or you talking about international momentum stocks.

Tim Mullooly: Anything that's not cap weighted.

Brendan: Yeah. Anything not market cap weighted.

Tim Mullooly: Which is a lot.

Brendan: Yeah. It's a ton to throw a blanket over. So it's kind of referring to hedge funds. It's like, well, this hedge fund and that hedge fund could be totally different. So to use a blanket and say, hedge funds are crap. I don't know. I mean maybe, maybe not. It seems like a very broad statement to make that could be very easily actuallied. And I think the same case could be made for Smart Beta. The growth is engine sputtering, but what does that mean? I mean, does that mean that value funds are taking in less or maybe international markets haven't done so hot this year, maybe their international Smart Beta funds are not doing as well or are-

Tim Mullooly: Could be more beneficial to kind of drill under the hood of smart Beta.

Brendan: Like our momentum funds are doing well.

Tim Mullooly: More specific.

Brendan: Exactly.

Tim Mullooly: All right, well that's going to wrap up this episode of the Mullooly Asset Management Podcast. Thanks for listening and we'll see you on the next one.