Ep. 232: Active Share, 2019 Contribution Limits, 401(k) Millionaires - Transcript

Tom Mullooly: Welcome to the Mullooly Asset Management podcast, this is episode number 232. I'm one of the co-hosts, Tom Mullooly. Sitting alongside me is Brendan Mullooly.

Brendan M.: How's everybody doing? Ready to chop it up.

Tom Mullooly: Yeah, let's pod it up.

Brendan M.: Yeah. The first thing that I wanted to talk about this week is an article that I saw on Vanguard's website. It was talking about active share, so like with active managers, how active are they being? For people who call it this, or don't call it this, people like the idea of being active, but important clarification from Vanguard here in this post that being different from the market does not get active managers like better returns. It just gets them different returns.

Tom Mullooly: We used to have the discussion, this goes years back, but we used to have the discussion where, "Hey, if you want to have someone who's going to manage the emerging markets sleeve of your portfolio, great, let's get someone who's really good when we used to have superstar fund managers." But understand that when we put all these different sleeves on, small cap value, mid cap growth, when we put on all these different sleeves, understand that there's only going to be one winner this year.

Next year the winner could be someone else, so you have to learn to live with the idea that there's going to be different sleeves in your portfolio and they're going to underperform at different times. That doesn't mean that you kick 'em out of the bathtub.

Brendan M.: Just the idea of the different statement. Being different can be a good or a bad thing, and often as this study pointed out, being different when being combined with high fees, as you often see in some of these mutual funds, tends to not be so great. Like, they had a distribution of it and it just mentally makes sense. Tim will link to this article in the show notes where they break it down in a graph, but they start with a bell curve and it's like, "All right, here's the middle of the bell curve, a line down the center, where this is the average investor's experience."

Then, they draw a separate one after the fees, then from there, there's one little tiny tail left of those juxtaposed bell curves that are somewhat laid on top of one another, and this one little sliver are the people who outperform, after their fees. Then there's a whole slew that perform better than average, maybe gross of their fees, but then net, they underperform.

Then there's obviously many more who underperform net and gross of their fees. If you're going to be active, you're going to be different, and at times that can be rewarding, but at other times it's not going to be, and that doesn't necessarily mean that it's good or bad. It just means that if you're going to be different, you have to be comfortable being different. Being different sucks sometimes.

Tom Mullooly: Yeah. You have to learn to live with the idea that part of my portfolio is ... I'm not going to hit a home run every time I come up to the plate, that there's going to be some part or parts, plural, where things are not going to be kickin' ass all the time. The other thing that I wanted to bring up is when we talk about active managers or active mutual funds, we always hear the phrase "closet indexers." You want to just talk a little bit about that?

Brendan M.: Right. They touch on that in this article, too. The idea that if you're paying active management fees, something higher than what you could get an index for-

Tom Mullooly: Then hit a home run.

Brendan M.: Yeah. Here's the problem, though, is that's not really what people want. They want to pay the active management fee and be guaranteed that they're going to get the positive side of the different performance. But the trouble is I think that the more different you are from the benchmark, the easier it is to get tired of the strategy because you're going to have both ends of the spectrum.

You're going to have hopefully, if you've selected a decent active manager, you're going to have some times where you outperform, and they're going to do well, or a combination of skill and luck, and they're going to do it. But there's also going to be a lot of times where they don't and if you're paying for the active management, with the idea that you're going to get outperformance and you get underperformance, probably more than 50% of the time, it's easy to be disappointed and I think that keeping people in a strategy like that is a lot harder than just being in something maybe is closer in line to the index. But you don't want to be paying those high fees and not even getting that at all.

Tom Mullooly: I think I just want to hit the pause button and just explain when we use a phrase like closet indexers, what are we really saying?

Brendan M.: We're saying that the fund is indecipherable from the index that they've said is their benchmark. If they are a large cap US stock funds, their benchmark is either going to be the S&P 500, or the Russell 1000. Some representative of US large cap stocks. If you look under the hood at what they have in their portfolio, they don't have anything much different. They're not taking any different bets than what you could get from the index, so if you're paying 75 basis points for that, or you could get the Russell 1000 index fund for eight basis points, then I think it's pretty clear what the preference would be. That's before even taking into account turnover and taxes, too.

Like, you have to be pretty good at what you do to outperform after that basis, and this applies obviously most easily to active mutual funds, but anybody who's putting together an investment portfolio, this applies to them too. It's not like we're pounding on this industry. Advisors make portfolios too, and they're not good sometimes, either.

Tom Mullooly: I was stunned to see back in the '90s, a stat that Dean Witter put out. Don't quote me on this because I'm going on memory and so it's foggy, but they had published a piece saying that the average mutual fund holding period was something like 4.2 years.

Brendan M.: Meaning how long the individual holds the mutual fund for?

Tom Mullooly: Correct. That's it?

Brendan M.: Think of all the turnover on different levels, though, okay? We have the individual only holding the fund for four years. We also have the fund itself turning over the stocks within it, sometimes at rates close to like 100% for active funds. They're literally buying all new names every single year for some of them. It depends on what kind of approach they're running, but think of all of these ... I'm sure the end investor doesn't realize, if they're turning over their fund and the manager's turning over the stocks, then like do they own any of this stuff long enough for it to do any good for them?

Tom Mullooly: It would have been an accident for some of these people to make money, because they happened to be in the right fund at the right time, when they caught lightning in a bottle. For some folks, I'm sure that was their experience too.

Brendan M.: It happens. it doesn't mean that it's repeatable or like a good approach or anything of that nature.

Tom Mullooly: I think sometimes that you look at guys like Buffett have racked up these kinds of gigantic percentage returns, things that look like a hockey stick, the wrong way, the opposite way, so it's flat on the bottom for the first 40 years, and then whoosh, all the way up. Primarily, I wonder sometimes if they're able to generate these kind of returns over long periods of time, because they just didn't sell. They just stayed with stuff long enough.

Brendan M.: Yeah. It's tough, though, because we were talking about it before. If you are different than the market, you have not only the performance in an absolute term, like, "Am I making money or not?" Yes or no? Because everybody fights that, whether you're in an index or an active fund, but when you're making active bets, then it's like, "Okay, am I positive or negative? And also am I positive or negative versus the alternative cheaper index that I could be using?"

You have all these opportunities to psych yourself out of your investment and rip up the script, because good investing is often like watching paint dry. Like, it's not meant to be exciting and definitely not going to be exciting when you're starting from smaller balances. Like, compounding is more noticeable when you get decades into the game. A decade's a really long time, though.

Tom Mullooly: It's a very long time. I think about when we used to see client accounts come in and they would have 5% of their account in something like gold or managed futures, or some kind of commodity trading pool or something like that, and we would just ask them, "What was the plan? What was the strategy?" "Well, we had some money in bonds, we had some money in commodities, we had a little bit of gold, we had large cap this, small cap that, international."

I anticipate that, I'm just thinking what those conversations would have been like. "Okay, so we've been in this commodity thing for like five or six years. When does the magic happen?

Why are we holding this? If we really believe it's going to work, why is it only 4% of our portfolio? If it's really going to work, why isn't it more?" These are tough questions when you want to have these active type of, I keep calling them sleeves, but they're portions of a portfolio, I think not only for the investor, but also for the advisor or the broker or whoever put this together, they almost have to defend these decisions to remind people, "Oh yeah, remember we bought that for the day that inflation gets to 12%. That hasn't happened now in almost 40 years."

Brendan M.: I think the problem is that people put together portfolios to be considered-

Tom Mullooly: All weather?

Brendan M.: No. To work as a whole, and if you're going to nitpick over a sleeve of the portfolio, then yeah, there's always going to be something to shake your hand at angrily. With stuff that isn't just stocks or bonds, it's more difficult to keep the end investor in it because it's not as understandable. That doesn't make them bad strategies. I think that a lot of them do make sense.

It's just the idea of explaining it to an individual, even a really good advisor might not be capable of doing that. Also, we're talking about again, active managers, this holds true also for people putting together portfolios using index like products in an active way. Whether it's an individual or an advisor, like you're always going to be different in some regards, and if you're going to let how different you are affect ... If you're going to second guess yourself after the fact, I think you're going to be ripping up the script all the time. You're never going to make any progress.

Brendan M.: Seguing, next year 401(k) contributions are going up to $19,000.

Tom Mullooly: Hold it. Hold it. I read about this. I read about this in the New York Times. You were in that article.

Brendan M.: I was. That was cool.

Tom Mullooly: That was on Saturday, I forget the date. Was it November 11th? November 10th?

Brendan M.: 9th? I don't know.

Tom Mullooly: It was in the New York Times on the second Saturday in November, 2018, and Brendan Mullooly quoted in the New York Times. Congratulations.

Brendan M.: Thanks. Yeah, that was cool. I spoke to the reporter who put together this article, Ann Carrns, and really just a basic post outlining these raises for next year. 2018, you could put 18,500 into your 401(k). Next year, you're going to be able to put up to 19,000. This applies to pre-tax and Roth contributions that you would make. Additionally, the 6000 catch up, if you are over age 50, still applies.

You still get that, no raise there. Potentially $25,000 of pre-tax and/or Roth contributions that you can make in salary deferrals into your 401(k).

Tom Mullooly: This is starting to get to become real money. I mean, a couple age 50 or older can put now $50,000 between the two of them into an IRA or a 401(k). This is starting to add up to real dollars and cents. When I got started in the business and they rolled out IRAs, this is in the early '80s, it was $2000. One person could put $2000. You could put away up to $2400 between the two of them. You could put 2000 in one, 400 in the other, or split it 1200 each. $1200.

Brendan M.: Well, I guess with inflation, right? You've got to adjust for that, but even still, I think raising these limits not only speaks to inflation but just the idea that anything we can do to encourage people to put more away for retirement is a good thing.

Tom Mullooly: Save more money. Blair, friend of the firm, wrote a post the other day about you don't necessarily need to max out your contributions to your 401(k) to retire and retire on track.

Brendan M.: Yeah. To jump, because there was an article in Forbes that said the same thing. Well, it didn't, so I read this one in Forbes about becoming a 401(k) millionaire. I thought of that post from Blair, because without context, have the goal of a million dollars in your 401(k) could either be like totally appropriate, not even close to being enough, or double what you need.

To put your savings plan into the context of some projections, now obviously those are not etched into stone tablets, but to just take a look at what you need to exist day-to-day right now, and this becomes easier and more concise as you approach retirement, but to do some numbers, I mean, like I said, a million dollars to some people, if you're spending a couple hundred thousand dollars a year on your lifestyle, it's not going to mean anything if you have a million in a 401(k) so why should that be your goal?

Tom Mullooly: It's pretty interesting to see, and this is totally unscientific, not any kind of regulated poll or anything like that, but it's interesting to see that there's a certain group of people out there who are just good savers. They have low overhead, they don't seem to spend a lot of money, they've got tons of money banked, they don't have debt, and they have a million dollars already saved in their early to mid-50s for retirement. The last people that need it, but well, they're going to have it.

Brendan M.: I think the common trait that you would find among those people is the first thing you said, which was low overhead. I think if you can keep your footprint small, you can save money and you can get by with a retirement account half the size of somebody else's if you don't spend insane amounts of money every year. If you do spend insane amounts of money every year, if you are saving very insane amounts of money every year to hopefully support that in the future, then that's fine, too.

As long as you're doing both sides of the spectrum here, the mismatch is where people get into trouble, where you are not saving, but spending lavishly. That's where you run into trouble. But also another point with this 401(k) millionaire business, it tends to be something, I feel like I've been hearing about this a lot, a lot more recently in the last year or so. It seems like there's been a lot of articles about it.

I just want to bring up the idea of anchoring two big round numbers in your accounts for investments, and how horrible that can be when it feeds into your decision-making process. It's impossible not to get sucked into stuff like this, but if your account was a million dollars and then the next week the market went down a percent or two, then you're back to-

Tom Mullooly: You're back to feeling miserable.

Brendan M.: Six digits, right? Or whatever.

Tom Mullooly: Being unhappy.

Brendan M.: Yeah, you're not in the millionaire's club anymore. But it's just like yeah, don't tether your happiness to whether your account is up a couple of percent each day to pass some arbitrary big ... We do this with the Dow too, and it's kind of silly.

Tom Mullooly: Can't believe it's not at 27,000 anymore. It's at 25.

Brendan M.: Remember the good 'ol days?

Tom Mullooly: Yeah, I remember when it was 1700, okay? I shudder when I hear us talking about things like don't tether your happiness to a number in your bank account or your brokerage account, or your 401(k) or something like that. Like we're talking to four and five year olds. But really, this is good advice for a lot of people.

Brendan M.: It's advice that's really easy for me to say into a microphone and it's not as easy when I have to look at my own account and fight off this feeling, because I think for whatever reason, it's natural. It's like you see some round number that's an easy thing to stick in your brain, and it gets caught there. But if you can catch yourself and realize how silly this is in the act, I think you can hopefully prevent bad decisions.

Tom Mullooly: I don't know. I'm going to say something that I probably shouldn't say, but I don't even look at my 401(k). I don't. First of all, I don't manage it. You do. You manage it for me. You charge me a very good fee. Thank you for that.

Brendan M.: Fair and equitable.

Tom Mullooly: But I will also say that I'm too busy working. I'm too busy working on a daily basis to really look at something like that. I know the automatic deposits are going in every pay period so I don't worry about that. I know at the end of the year I'm going to max out my contribution, I'm going to do my catch up contribution. I'm going to be okay. I'm putting money away for retirement.

The market will do what the market will do, and I don't look at it. If I don't look at it, I just wonder sometimes, why do people get obsessive about this stuff?

Brendan M.: Yeah, I think sometimes it's fine. Some people are just wired to be able to look every day and it doesn't bother them or register on some kind of emotional level, but I think for a lot of other people, it may be that underlying, "Am I going to be okay?" And hopefully for us, when we meet with our clients and we discuss the bigger picture with them, and we're able to give them that peace of mind so that they don't have to frantically look at their account balance and I really, I feel like that's ultimately what it goes back to.

If round numbers are something that are seriously giving you anxiety, I think it's more going all the way down to that base level of will there be enough? Am I going to be okay? Part of that, that is what we do as advisors, is help people to come up with some numbers and information that can hopefully comfort them to feel like they're going to be okay.

Tom Mullooly: Now, there were some other things that didn't quite make it into the New York Times article which is pretty amazing, because their slogan on the masthead is, "All the news that's fit to print." But they didn't some of the things that you discussed, did they?

Brendan M.: Well, I think they were trying to keep it pretty basic for the post, and so they touched on stuff that I think is probably most useful for the average reader. But some of the other things that I brought up in this interview that I did with Ann, the after tax 401(k) contributions.

Tom Mullooly: Boy, a lot of people missed that.

Brendan M.: Yeah. If you are sending in your 19,000 for 2019 now, or 25,000 if you're aged 50 or older, and you want to do more and you want to do it on a tax deferred basis, you can in many plans now, about 50% of plans are offering this, so you have to check with them first, but many plans are allowing after tax 401(k) contributions. You can make these up to $56,000 would be the total between your pre-tax-

Tom Mullooly: Pre and post.

Brendan M.: ... contributions, Roth contributions, employer match, and then whatever else you can do. The top line number is going to be 56,000, with 6000 of-

Tom Mullooly: Catch up.

Brendan M.: ... catch up for those who are old enough to do that.

Tom Mullooly: Again, you've got to check your plan to see if your plan allows it, but like Brendan said, nearly half of the 401(k)s in existence right now allow these types of features. If you're a saver, this is a really good opportunity.

Brendan M.: Yeah. I think one of the best things for people is that most of the time people in a position to make these kind of after tax 401(k) contributions have pretty high incomes and they may not be eligible to do things like a Roth IRA that they may want to do to have different streams of income in retirement.

Tom Mullooly: This kind of accomplishes the same thing.

Brendan M.: That's I think one of the best features, is that when you do retire from wherever you have this 401(k), if you've made after tax contributions, whatever those contributions are will be eligible to be rolled into a Roth IRA upon your retirement or departure from the company. You'll have two rollovers to do. You'll do one with your-

Tom Mullooly: Pre-tax.

Brendan M.: ... pre-tax and all of their earnings and whatever earnings you had on your after tax dollars will go to a traditional IRA, and then any after tax contributions you made go to a Roth IRA which is nice. I mean, you don't have to take RMDs from those accounts as of now, you get the money tax free in retirement. Once you roll it over, you do have that five year waiting period to do the distributions from the plan, but it can be a way to get money into a Roth IRA that doesn't involve Roth conversion, and one that you aren't limited by because of a high income.

Tom Mullooly: Because of the income threshold, right? Pretty good.

Brendan M.: Something worth asking about at work if you're looking for a place to stick extra dollars, because I mean above and beyond that, there's not a lot on a tax deferred basis you can do, aside from something small maybe like an HSA if your medical plan is high deductible.

Tom Mullooly: Health savings plan, you know what? Really good idea, but in order to be eligible for a health savings account you have to be in a high deductible plan. High deductible plans, even with the name high deductible, like a $5000 out of pocket or something like that, they're still really expensive plans.

They're very expensive and the first five grand or maybe $7500 is on you.

Then, if you happen to be stuck in one of those plans, oh, you can still put a couple of grand away each year in a health savings account. Those people are, it's tough, they're strapped.

Brendan M.: Yeah, I think for most people, if you are going to take advantage of something like an HSA, I think you need to be rock solid, sure that you have a good emergency fund set up with not only three to six months of your expenses, but if that number for whatever reason doesn't match the deductible of your healthcare plan, you want to have these kind of numbers set aside so that if you're going to use an HSA as a retirement savings vehicle, which many do, you want to be sure that you're not going to have to put money in this year, fill it up to the max and then pull it out because of a medical emergency. Because then what was the point of even having that in the market?

Tom Mullooly: Correct.

Brendan M.: You don't want that. You don't want your emergency funds in the stock market.

Tom Mullooly: Not that we planned on talking about this, but putting money into an HSA, you can't take it out to pay premiums. You can take it out to meet your deductible, but again like you just said, if you're putting money in and you're taking it out later the same year, what's the point?

Brendan M.: Yeah. It may not be the Venn diagram of people who are eligible for an HSA and also have the means to actually utilize it in a safe manner as retirement savings. That centerpiece may not be so big in the Venn diagram.

Tom Mullooly: There's a needle in the middle of that Venn diagram.

Brendan M.: You don't know. Maybe. If you are a small business owner maybe, you fall into that. If it's there and you can do it and do it in a way similar to what we've just described, worth exploring a little bit more, because it is pretty cool. Those accounts are, the buzz phrase is what? Triple tax free, because you're going to get a deduction for the contribution, tax free growth, and then tax free distribution in retirement.

Tom Mullooly: My account's probably going to pay for one CAT scan at the end. CAT scans by then will cost 150 grand.

Brendan M.: At the pace we're at, you're probably right.

Tom Mullooly: That's the thing. We talk about inflation and the rate of inflation, when we're managing investments, we want to be sensitive to historical inflation and never lose sight of that. That's why fixed income investments will give us some kind of income but they're not really geared to keep up with inflation.

But the problem is I hate to be a jerk when I do this, but when people start talking about how much they need for retirement, I'm like, "Wait a minute, you don't even know what a cup of coffee is going to cost in 2042. You just don't know. There's no way of saying that."

Brendan M.: Because at a certain point, if you have that mentality then it's just like, "Oh, so why even bother doing planning?"

Tom Mullooly: It's hopeless.

Brendan M.: And I think that that's a bad mentality to have, and it's not helpful.

Tom Mullooly: Really the plan, save more money, step on the gas, put it into growth investments until you get to a point where you're getting close to when you need to take 'em out.

Brendan M.: Yeah. I think you can quantify it a little more for people who would like some guidance in terms of what is-

Tom Mullooly: Okay, that's my back of the envelope plan.

Brendan M.: No, I mean it's generally correct, but I think it's like taking a little bit of value of doing planning work which I don't agree with. I think if you can quantify for people, what does save more money mean? If you tell somebody that, what are the odds they're going to do it?

Tom Mullooly: They won't. I should eat less, I should exercise more, but you don't. Yeah, you're right.

Brendan M.: These are truisms that we all know and they sound great, but maybe if you can help somebody put a plan into place that actually gets them to do that in a specific amount, and you could show them how it fits into what they're doing now, I think maybe the odds then become a little bit better that people may adhere to the advice that you're dolling out.

Tom Mullooly: It would be an interesting exercise for all the listeners out there to email us how you're able to cut $200 out of your expenses on a monthly basis. Show us how you did it, or how you plan to do it, because I think that's where the rubber meets the road. Like, "Hey, can I put $2500 away in the next 12 months so we can go away on a small vacation?" 2500 bucks will actually get you a couple of days in the Bahamas.

I think doing things like are meaningful, very different from what I just said, the back of the envelope, "Hey, just step on the gas, save more money." Being specific about it is really where the planning can help people. I'd be really curious, send us an email and let us know how you were able to find $200 of excess or fat in your monthly budget, and what you did about it.

Brendan M.: Yeah, I think having something quantifiable like that is helpful.

Tom Mullooly: All right, that's all we've got for today's episode. Thanks for tuning in and we will catch you again on the next one.