Outperforming Cash, 2018 Gains/Losses, Tax GAIN Harvesting - Transcript

Tom Mullooly: Welcome to the Mullooly Asset Management Podcast. I am Tom Mullooly. I'm here with my co-host Brendan Mullooly.

Brendan M.: Ready to discuss some good topics this week.

Tom Mullooly: Ready, fire, aim.

Brendan M.: Yeah.

Tom Mullooly: This is episode number 234. Thanks for tuning in.

Brendan M.: Ben Carlson had this post like last week about ... It was called When Cash Outperforms Everything. So these numbers might have changed by now but he was just talking about how at this point last week, we had seen cash outperform both stocks and bonds over the course of calendar year 2018, which is pretty rare. It has only happened a handful of times in history going back to 1929. But I thought the point was just well made that he looked back at rolling 12-month periods back to the '30s. Stocks outperform cash like 70% of all rolling 12-month periods and bonds-

Tom Mullooly: Wait. Say that again.

Brendan M.: Stocks outperform cash in 70% of rolling 12-month periods. And bonds outperform cash 66% of rolling 12-month periods. So if you have a traditional portfolio where you have some mix of the two of them, most of the time one of them at least is going to outperform cash, and a lot of times both of them are going to outperform cash. But every once in a while you're going to have a year where both of them underperform cash. And that doesn't mean that like something's wrong or things are broken, it just means that you're playing a probability based game-

Tom Mullooly: Sometimes you're going to be on the losing side of a trade. That's just the way it is. I think the problem is when you look at when cash outperforms bonds or stocks, the next question in my mind is, for how long? I mean, this may be that period from, I don't know, July of 2008 until March of 2009, cash was clearly outperforming everything. Other than that, it's been like I'm sure Ben alluded to in the message in his post a couple of weeks here and there where cash outperformed either stock market or bond market. It's a temporary situation.

Brendan M.: Yeah. I think that in either case, they're both .... Like Ben alludes to them being like risk assets they are. So you look on the spectrum of like risk you're taking and there's cash on one end and then like bonds are somewhere along the way and obviously stocks are further out than that. But when you invest money in risk assets, you're being rewarded for taking that risk, and the risk being that it's not always going to work. And especially not over a short timeframe like one year. If you stretch these out to 3 years, 5 years, 10 years, those percentages get better and better but they're not perfect either.

Tom Mullooly: No.

Brendan M.: That speaks to like having a diversified portfolio too because this is looking at just US stocks and bonds. I'm pretty sure running numbers off of S&P 500 and aggregate bonds. So the first thing that comes to mind for me is that you had a period from 2000 to 2010 where cash outperformed US stocks as measured by the S&P 500 for 10 years. But that only looks at large cap US stocks. If you had small cap US stocks or small cap value US stocks or international stocks-

Tom Mullooly: You did fine.

Brendan M.: You did fine. But again, all of those are going to have the same similar numbers in terms of how often they outperform cash over a 12-month period, but they're going to happen at different times. So if you piece these things together, you're never going to have a portfolio that is guaranteed to outperform cash over a rolling one-year period, that's that shouldn't be what your goal is anyway, so that's okay. You don't want to add a million pieces but if you add things like international stocks to complement your US stocks with bonds to complement both of those things, I think the odds of having pieces of your portfolio ahead of the game each year or over longer stretches, it's going to be pretty good.

Tom Mullooly: It is going to be good but the problem then becomes, suppose you've got nine sleeves in your account. You've got small cap, you've got large cap, you've got international, you got emerging markets, you've got fixed income. I'm running out of fingers. But each of them represents about 10 or 11% of portfolio. Is the 10% that's in international going to save or bailout the rest of the portfolio that's going down the drain? Probably not.

Brendan M.: I mean, we're that it's just 10% into each of them. That's maybe not the case. I think-

Tom Mullooly: May not be.

Brendan M.: I think the big part of like portfolio construction is thinking about these things like you just said, thinking all right, so what if this is the good piece and the other ones stink. Or what if that is the good piece and the other ones stink. And balancing those things to make sure that you have enough exposure where you need it in different areas so that they can pick up the slack for the other ones. I think that's something that a lot of people in the US do a bad job of. I think it's actually across the globe in terms of home country bias.

Tom Mullooly: Sure.

Brendan M.: But it's been rewarded for us investors since around 2011 or 12, not longer than that. I can see your face.

Tom Mullooly: I'm trying to go back in time think, no, that's not true.

Brendan M.: It is true.

Tom Mullooly: Goes back to 1982?

Brendan M.: No. If you looked from the bottom in 2009, international stocks did at least as well as US stocks coming out of the financial crisis until around 2011 or 12 and that's where the divergence really started. But now we're going on 6, 7, 8 years of US sock out-performance. Obviously, international stocks had some years along the way in there, but by and large people have been rewarded for only having US exposure.

Tom Mullooly: I'm just thinking of 2011 was the first year that we started hearing about countries like Egypt, Tunisia, Greece where some of these markets started to implode. Make sense.

Brendan M.: Yeah. But overarching point being that just because people have been rewarded for only having US exposure for seven years, I mean, in terms of what we're looking at in market history is that we want to continue making that bet forever into the future?

Tom Mullooly: No.

Brendan M.: I don't think so. And how do we know when the tides are going to turn? We don't and we're not going to. Obviously, this year hasn't been a good story for US or international stocks but thinking back to last year, when was the signal in 2017 that international stocks were going to be up more than US stocks?

Tom Mullooly: There was no signal.

Brendan M.: There wasn't one.

Tom Mullooly: It just was.

Brendan M.: Right. So either you're going to be chasing into that trend after the fact or-

Tom Mullooly: Or you're you going to own it through.

Brendan M.: Or you can think about how much exposure you want to have to international markets. I'm not saying it has to be 80% of your portfolio, but you probably want to have a piece of your portfolio allocated too there. Obviously, that's going to be determined by a whole host of things.

Tom Mullooly: Similarly, along the same lines of cash outperforming different asset classes this year, I saw an interesting tweet from Jeff Ptak of Morningstar. Again, along the same lines, it looked at the number of mutual funds and then he broke it down into percentage too of mutual funds with losses versus gains by year. And so he went back to 1999 and put out some graphs just looking at whether mutual funds made or lost money over each calendar year. Again, this is only through ... I think he posted earlier this week. But the percentage of mutual funds with losses so far in 2018 was approaching about 80%, which is high, very high.

Brendan M.: Just speaks to the idea that there hasn't really been in terms of like risk assets, stocks or bonds across the globe US, international, there have not been many areas to date right now so far this year that have made money, and so that I think speaks to that mutual funds. Whether they're large cap US or developed markets internationally-

Tom Mullooly: Active versus passive.

Brendan M.: Right. Like there hasn't been money to be made and so yeah. I mean, like the whole notion that maybe active management should shine during a period like this because there's a big discrepancy across performers and out-performers, under-performers in terms of the dispersion that they speak of. It doesn't seem to have helped at all this year to pick winners or losers. Interesting to look at like a year like 2017, basically everybody made money since this chart has nothing to show. The last difficult year looks like 2015 where the reading came in just over 60% from what I'm seeing here. Obviously, a year like 2008 about 90% of mutual funds didn't make money.

Tom Mullooly: You may not know this but when Jeff was putting this together, is he going year by year saying okay, in the current year 2006, how many funds made money versus loss money? Or is he looking back? The reason why I'm asking is, in the industry we know this but I don't know if a lot of listeners know this when a mutual fund family owns a fund and they see a lot of outflows and they see poor performance, they just closed the fund. So that also skews the numbers in the sense that when you look at some of these mutual funds that have been around for a long periods of time, they may not have originally started that way. They could have had another fund merged into them. Or these funds could have been closed, all their competitors went away. They were the only one left in the sector.

Brendan M.: Yeah. I think this just looks in a vacuum. Like you said, 2006, of all the wasted mutual funds and he used like the lowest cost, oldest share class, so institutional for many of these. He had little like a little heat map, chart too to layer on top of this percentage that showed if they made or lost money, it kind of color-coded it in green and red. Like bright green to dark red in terms of if they made money, like how much? And if they lost money, like how much? And it broke it down into like 0 to -10%, -10% to -20% for the returns and so the bar in 2018 was very light. Meaning that the gains that have existed for the 20% or so that have made money are between 0 and 10%, and a lot of the losses for those that have lost money are between 0 and 10%. Meaning basically a lot of the mutual funds this year have done nothing, which is more or less what a lot of the major market indices have done too.

Tom Mullooly: It's pretty interesting because next week is typically the week where these mutual funds go ex-dividend. Where they've declared by now how much the dividend is going to be, what the capital gain distribution is going to be. Next week is when we get calls from people who may not have heard the news. Hey, why is my mutual fund down $7 on a day when the market did nothing? That's the day when it goes ex-dividend, and if you're reinvesting, no problem.

Brendan M.: Also, if you own them in an IRA, no problem.

Tom Mullooly: Yes.

Brendan M.: If you're being surprised by a big capital gains distribution in your brokerage account, I feel sorry for you.

Tom Mullooly: Yeah. You should have a conversation with your broker about that. So I think the real wake-up call for some people is going to be that there will be capital gain distributions this year even though these funds are not going to show gains.

Brendan M.: Great point. That's overlooked. If everybody ends up around where they are, meaning there's a few out there that end up slightly positive, you'd get a little return for the risk you took on this year or you lose a little bit of money which is the case for many of these.

Regardless of that, you may have tax implications depending on where you hold a fund like this and what they needed to sell during the year.

Tom Mullooly: Well, CEOs and CFOs take a lot of heat because sometimes they will manufacture or massage or manage their earnings at their quarterly earnings release, and say yeah, we were able to beat the estimates by a penny.

Brendan M.: Sure.

Tom Mullooly: I just wonder how much massaging goes on as a year like this rolls on where a mutual fund manager says, we really ought to sell that position. But I'm going to unleash a lot of capital gains, so I'm going to sell that position instead where I don't have a lot of capital gains. I just wonder how much of that gamesmanship goes on behind the scenes.

Brendan M.: There's a ton that goes on behind the scenes, so to speak, at mutual funds. Even when we're talking about like an S&P 500 Index Fund, there's a person who has to manage the Vanguard 500 Index Fund. I'm pretty sure I heard him interviewed. I forget where. But it was pretty interesting to hear how they have to stay on top of stuff like this. Like if they need to match an index, they need to do what the index is doing but then they don't want to have a big tax burden for the people that own the fund. And so they have to be smart about we're going to sell a lot of this stock and pair it with this one and that to net to zero so people get the exposure they're hoping to get and without tracking our ... Especially from an index fund, you don't want tracking error there.

With an active fund, you'd hope that they're being intelligent about when they recognize these gains or not as well. But I know we discussed back over the summer something that that Jeff Ptak wrote from Morningstar about a pretty good international fund that has just had a lot of withdrawals this year and a little bit of trouble in terms of international stocks being down, and had sold a lot of positions already where they have losses and now have reached that point that you're describing where, hey, there's nothing else to sell them we have to meet some redemptions. So we're going to sell this stock that we've held for years and years. Yeah, it's kind of out of their hands at that point. So you hope that you don't get there with funds that you own.

Tom Mullooly: It's a lot of work for a couple of basis points. Trying to land the jet on the aircraft carrier.

Brendan M.: Yeah. It's a lot. Like I said, for an index fund, there's a lot that goes on behind the scenes but even you think of it for a couple of basis points. But if it's four basis points on the Vanguard 500 fund, how much in assets do they have though? I mean, four or five basis points is still a lucrative business or they wouldn't do it.

Tom Mullooly: It's still real money.

Brendan M.: Yeah. Of course, if it were four basis points on 10,000 bucks, then they wouldn't put in the work but they have enough to pay a team of people to manage a fund like that still.

Tom Mullooly: So we talk about tax loss harvesting for clients and we talk about moves that we should be making at the end of the year. I'm just curious, anything else we ought to be talking about?

Brendan M.: Yeah. Tax loss harvesting, definitely a timely topic in a year like this where many things have maybe underperformed over the course of the year. So we want to stay on top of stuff like that. But Christine Benz that Morningstar wrote a couple weeks back about tax gain harvesting, which I think is something people would be like, wait, did she mean

Tom Mullooly: Did she say that wrong?

Brendan M.: Did she mis-speak? But not the case. She was talking about something that isn't going to apply for a ton of people but it's something to be aware of. There is a 0% capital gains rate that exists if you have income low enough. So if you're a single tax filer below 38,000 or so in taxable income or a joint filer below 77,000, these numbers are for 2018, you may not be in a position where you owe any capital gains tax. And so if you have a brokerage account and you have highly appreciated stock or a mutual fund that you've owned for years and years that you have gains in, you don't need to worry about taking those gains from the account and recognizing them. Even if you don't need income at all, you could sell these things, buy them back the next day because there's no wash sale rule for a tax gain harvesting.

Tom Mullooly: It's only on tax losses.

Brendan M.: Right. And for those you have to wait 30 days after you take a loss if you want to buy the same position back.

Tom Mullooly: Right.

Brendan M.: For tax gain harvesting, you could sell a position that you've owned and you have big gains in, recognize a gain and if you're still below those income levels after taking into account the income that you get from the sale of that stock or fund, you're not going to owe any extra taxes on it. You can just buy it back the very next day and just have a totally new cost basis in it. It's kind of how ETFs operate in a sense where they're constantly turning over their portfolio each day to own shares with a higher and higher cost basis, so that when sell shares to match an index or do something that there's no tax liability for the end-user.

Tom Mullooly: Right.

Brendan M.: So it can be smart if you take a look at these things.

Tom Mullooly: It's pretty helpful. There's ways that I think an investment advisor or financial planner can be creative with their clients especially as we get to the end of a year like this where the market, like you said, hasn't really done anything. We did have some gains earlier in the year, some recent turbulence in the market. We don't know where it's going to end up with a month to go. But you look at these things and say, hey, it's time to really talk about being creative with things that you do. I know in a previous podcast and also with some of our guest, we talked about making charitable donations in the year that you do a Roth conversion.

Brendan M.: Yeah.

Tom Mullooly: Something like that. So there's certainly ideas out there where you can take advantage of these types of things. I have to admit, I read the same article and I saw tax gain harvesting and I said, that's a typo. That's got to be a mistake.

All right. I think that's going to wrap up episode number 234 for today. Thank you very much for listening and we will talk to you again real soon.