

Ep. 237: Putting 2018 in Perspective - Transcript

Tom Mullooly: Welcome to the Mullooly Asset Management Podcast. This is episode number 237. Two hosts for you today. Two hosts, no waiting. I'm Tom Mullooly and with me is Brendan Mullooly and we're here ready to tackle the most important financial concepts of the day. So Brendan, a lot of volatility going on in the market.

Brendan: Yeah, this market has been crazy, right?

Tom Mullooly: Yeah.

Brendan: We may be headed towards one of the worst fourth quarters ever and maybe, I don't know about December, but I think we might be on the list for that too in terms of performance.

Tom Mullooly: We're recording this on December 26th, so there's still a couple of days left in the month, so it's possible that we may recover a little bit, but so far it's been the worst December on record, since the depression.

Brendan: Whether we're going to be historically bad or just plain old bad, it hasn't been a good month.

Tom Mullooly: Just on an off shoot of that, when the depression was going on, did people know it was a depression?

Brendan: Oh man, I mean-

Tom Mullooly: Didn't they quickly named the recession that we had in 2008, The Great Recession? I don't remember it being great. I just wonder if people, they just said, this is life, the way it is. Later on the next generation called it The Great Depression.

Brendan: Yeah. Interesting to think about it that way. Yeah, I don't think we generally have names for things in the moment.

Tom Mullooly: Right.

Brendan: It's mostly just a tool to help us throw a blanket over a period of time that had similar things occurring throughout it, I suppose.

Tom Mullooly: Same thing like World War I. I mean, they called it a world war, but they didn't call it World War I because they didn't know there would be a World War II.

Brendan: Yeah. Yeah. Was it the war to end all wars?

Tom Mullooly: I think so.

Brendan: The great war.

Tom Mullooly: Right. This is totally unrelated and we're already way off the agenda.

Brendan: We're meandering. It's all right. We'll get there.

Tom Mullooly: But, I thought one of the smartest things that they could have done when they came out with it, was it Quentin Tarantino who came out with Kill Bill? The title of the movie was Kill Bill, Volume 2. Like they went straight to volume two. Like, okay, now, we can do a volume one. We can do a volume three. I thought that was good marketing, Volume 2.

Brendan: It would have been embarrassing though if the film tanked because then they would never have gotten to fill in the blanks like that.

Tom Mullooly: Right. Yeah. Kill Bill Volume 1, nah, no thanks.

Brendan: Yeah.

Tom Mullooly: The second one wasn't very good.

Brendan: Yeah.

Tom Mullooly: Yeah. Anyway, you had some interesting bits from Charlie Bilello, friend of the podcast.

Brendan: Charlie looked at a handful of ETF's, so I think there are about 10 to 12 on this list, but more or less comprising all the different asset classes that you could potentially invest in. So we have things like US large and small caps, emerging markets, developed markets, preferred stocks, high yield bonds, investment grade bonds, treasuries, long duration tips, aggregate bond, REITs, gold, commodities. So pretty much covering all your bases here in terms of how you could put your money to work.

Tom Mullooly: Different ways to play, different styles of investing.

Brendan: Yeah. They're all on here and if you look at the 2018 year to date returns, the only one that is positive. This is as of the 19th, so last week, but the only one that's positive is Treasury bills. So super short term, high quality, government bonds.

Tom Mullooly: Now, I'm curious. We don't have the data, but I'm curious if we were to go back exactly one year from today, go back to the end of December 2017, I think all of these areas would be positive. Instead of now, they're all negative and I would bet most prognosticators would tell you 2018, is going to be a similarly good year for this style approach. If you're in small caps, great. Guess what? We're predicting another good year for small caps. Mid-caps. REITs, utilities.

Brendan: Especially coming of, and we actually do Charlie, it goes back a decade in this chart, just to give you some historical perspective because 2018 is very unique. This is the first time in

a very long time that only one asset class would be positive. Even 2008 had more asset classes positive than this.

Tom Mullooly: That's right.

Brendan: But to your point, 2016 and 2017, everything on this list was positive.

Tom Mullooly: Right.

Brendan: That was the type of market environment for two years essentially where you could have been in anything, investing any way you wanted and it would have seemed like it was fine. You didn't have to give it much thought. There weren't a lot of ways to lose money. In 2016 or 2017.

Tom Mullooly: Now, I'm going to hit the pause button on this because 2016 didn't really start out very nicely.

Brendan: No, we had a 10, 15% draw down to begin the year.

Tom Mullooly: I think a lot of people forget that. I know that on February 11 of that year, we were down, correct me if I'm wrong, but I think we were down like 12 or 15%.

Brendan: It was about that.

Tom Mullooly: We managed to finish the year in okay position, so these markets do recover and they can recover quickly.

Brendan: Just going by the S&P which is what you were quoting from February through the end of the year, it pretty much round trip. So if was, let's say it was down 12%, it finished up 12%. So it went 24% round trip and even more at some of these more volatile asset classes. Like emerging markets and small caps probably and bear markets at that point..

Tom Mullooly: At the beginning of 2016, they were. But-

Brendan: Both of them finished up gangbusters even more than the S&P 500. So obviously it doesn't always work out this way, but more risk, more reward there. At least in that one year window.

Tom Mullooly: But, I'm going to deviate from this for a second just to remind listeners that right now, today, as we're recording this, market's up 2%. Even though on Monday, we hit down 20%, we have to remember our mile markers. Where we are. So we're down 20% from the top of the market, but for the year, S&P on Monday was down, what for the year? Maybe 12. So we may finish a year where we're down 10%, and honestly, there's been conversations that we've had over the years where clients call and say in January or February, hey, I see that the market did this. But we did that. Why were we so much worse than the rest of the market?

Right now the headline is we're in a bear market and we're down 20% from the high, but the market may finish the year in the next few days down 10% and so we're going to have some conversations with investors who say, market lost 10%, but I lost 20% why? So I think it's important to keep everything in perspective in terms of are you measuring from the top of the market, are you measuring year to date? It's important. Because I think a lot of people confuse this and again, I know we're getting away from what we wanted to talk about, but I think this is an important topic. Because I think this is the stuff that gets lost in the sauce.

So yeah, at one point, the market was up 10% this year, now we're down 10% this year, so there's your 20% spread between top and bottom. But for the year, the market may only be down 10%.

Brendan: Yeah, it's important to know how you're measuring stuff. Is it like you said, is it year to date, is it from the highs? Is it rolling one year, three year, five year?

Tom Mullooly: Humans being humans will say when the market's down or when an investment's down, they're going to measure it from the tippy top. I remember when this stock was \$500 a share and now it's down 20%. What they don't say is hey, from a year ago, it was here, we went up, we went down, now we're here. Hard to keep everything in perspective.

Brendan: Nobody likes losing money in the market, but all said, we were at these levels on the S&P 500 and the Dow at some point in 2017.

Tom Mullooly: Yes.

Brendan: Probably summer, fall of those years. Is it great to be back at those levels? No. Is it a catastrophe? Probably not. Assuming that you had a plan in place and you were invested appropriately. If you build a financial plan that assumes that this is never going to occur, then yeah, you're going to be in trouble. But I know just from what we're doing, we're building plans that assume a rate of return obviously and within that rate of return, you do something called the Monte Carlo simulation where you assume that hey, there's going to be a year in there where maybe we lose 10% on the year like what you were discussing. Or we endure a 20% draw down on the market. And that doesn't mean the same for your account necessarily, but that's just to say that you should be baking in years like this to your plans because they are going to occur. And if you're not, then you're going to be in trouble. If you're assuming that you're never going to have stuff like this happen.

Tom Mullooly: Never going to have a year with losses.

Brendan: Then man, I mean, I'd love to build plans like that, because it would be really simple. We're never going to lose money and everything will be great and you can withdraw as much as you want forever. It doesn't occur that way.

Tom Mullooly: It doesn't work that way.

Brendan: Yeah, so basically the way Charlie lays this out is the way that we like to look at these asset class returns.

Tom Mullooly: And Brendan, you've brought the quilt into some client meetings, so I'd like you to just expand on that a little bit for our listeners.

Brendan: This one's a little more in depth than some other versions, but many times around this time of the year, people will update these. Basically it's a matrix and it will show you on one end the calendar year and the other end it will show you different asset classes that you could have invested in and what their returns were. And it will color code each of them so REITs will be yellow and large cap stocks will be red and bonds will be green or what not. And each year it will update the order to show you which was first, second, third, fourth, fifth, all the way down the list. And when you put them in color like that, you can see that it looks like a quilt meaning that there's not a pattern. This is just a random thing. Sometimes something is the best performing asset class for a year or two in a row. Sometimes it goes from being the worst to being the best or from being the best to being the worst.

I think you can look at these quilts and interpret them in different ways. One that I think you should not do is look at them and say, ah yes. Here's the top one or two ... This is where we should have been last year.

Tom Mullooly: That's almost always a recipe for disappointment.

Brendan: Yeah, I think I've actually seen somebody run the numbers where if you bought last year's best performing asset class or people will do this with different investment styles sometimes, you're often setting yourself up to just lag because you're chasing performance. The way that we bring this into conversations with clients is that the quilt shows us why we need to have some semblance of diversification in our accounts. Because we cannot predict whether small caps are going to be better than developed market stocks or US large caps or bonds or a year like this year where short term bonds are the only thing that makes any money.

And Charlie kind of touches on that too. And he follows up his chart with this part of his article that says, you'll hear many opportunists today suggesting that 2018 proves that diversification doesn't work. Ignore these people at all costs. And I agree wholeheartedly with that. I don't think that a year like this year where pretty much nothing makes money proves anything about diversification other than that you should practice it. And I think somebody that's making withdrawals from their account, living off their money already probably has some money in something like short term bonds and that's hopefully what they're going to be living on for the next few years.

Tom Mullooly: But we follow the same practice here at the firm. In terms of this quilt approach.

Brendan: We look at it to tell us why we need to diversify the account across some of these different styles of investment or asset classes.

Tom Mullooly: And we've shown this to clients where we lay out the quilt in front of them and we show them hey, this year, in one particular year, small caps and then international did well and then large caps came out of nowhere to carry the flag. Tell us which one of these groups is

going to be number one next year, because we don't know. They don't know either. And so that's why we need to own, have assets spread across these groups.

Brendan: Obviously the degree to which you do that is going to be determined by the client's situation and the plan that we're putting together for them, but yeah, I think anyone who tells you they can look at an asset class quilt and then predict next year's performance, if they happen to do it for a year, I would say the results are luck. I would love to meet somebody who does this each and every year and has documentation for their track record for predicting the future, because I think most people would just say next year's going to be the same as this year. And then when it isn't, it's oh well. Easier to make predictions. A little harder to tell the truth and say we don't know, but we exist in a world where people who understand the truth know that they don't know and still have to come up with plans about how they're going to invest their money in a world where we cannot predict the future. And I think this is probably one of the more logical ways to approach that.

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Tom Mullooly: I agree. Ben Carlson did some work on bad quarters.

Brendan: Yeah, so this ties in kind of where we started the conversation with December and just the fourth quarter in general being kind of crummy in terms of what's gone on in the market. And Ben looked at quarterly returns since 1926 and that have him 370 quarters of data to look at. The fourth quarter of 2018 made the list in terms of worst quarters so far, but it's not at the top and in fact, some of the worst were nearly double what we've experienced. Which is pretty wild.

Tom Mullooly: There's a lot from The Great Depression that are in there. Some 1929, 31, 32. I mean those ... You look at those markets and you realize, okay, you take a year like in 1929 where the market was down 25 or so percent. Then you follow up a year or two later with another 30% percent drop, followed by another 30% drop, it's hard to believe you can have those kind of numbers doing some negative compounding for you.

Brendan: It's brutal. The thing to keep in mind I think is that you can make a case that in the 20's, 30's that America was still what we may consider today, an emerging market.

Tom Mullooly: Sure. I mean we were only 50 years from the Civil War. Hawaii and Alaska weren't even states.

Brendan: And you do see quarters like this when you're investing, especially ... This is looking at just the U.S., so try to think of not emerging markets broadly, but maybe just one single emerging market. Like one country. And I'm almost certain you would see quarters like this. Like what the Great Depression had here. It's tough to remember that when we think of the

United States because today, U.S. markets make up about 40, 45% of global market cap. So we're used to thinking this behemoth that has the biggest and the most efficient markets in the world, when that wasn't always the case.

Tom Mullooly: Definitely not. I mean, just to take those numbers we just cited into perspective. If you started with ... There's a lot of these things that we see online. We follow a lot of the same people on Twitter that Tweet out these things. If you invested \$10,000 in fill-in-the-blank, you'd have you know a bazillion dollars. But if you invested \$10,000 into the Dow Jones in 1929, your \$10,000 would become \$7500. I don't know what it did in 1930, but let's just say it did nothing. Your \$7500 in 1931 became \$5000 and then your \$5000 in 1932, became \$3700. You've lost two-thirds of your money. How does anybody stay in an investment strategy long enough to even get back to even?

What happened during that period kept generations away from investing in stocks. I mean I grew up-

Brendan: It wasn't really until almost the 50's when things really started to improve. I mean you had World War II going on and that consumed a lot of the 40's and markets weren't very good immediately following that either. Back to what Ben was talking about here with these quarterly declines, he looked at these worst quarters of all time and then juxtaposed them with forward performance from these terrible quarters. So these are I think the worst 10 in history for the S&P 500 that he looked at. And he looked then at what the market did one year out, three years out, five years out.

The average return one year out from these really bad quarters which range from down 37% to down 17%. So by any standards, all these were really tough to deal with. One year out from these quarters, the average performance was up 25%. Three years out, it was up 38% and five years out, up 91%.

Tom Mullooly: Pretty good numbers.

Brendan: Obviously doesn't speak to the pain felt while they were occurring, but I think it does put things in perspective in the sense that more often than not, performance is going to be getting better in terms of what you should expect in the future when things are getting worse in the present.

Tom Mullooly: So for folks that are listening to this podcast and they contribute to a retirement plan at work, the best advice we can tell you is continue to contribute to your retirement plan. We do get calls from people when the markets are down like this saying I think I should have all my contributions going into the money market or into some kind of stable value option that they have in their plan. That may be -

Brendan: That's a really bad idea.

Tom Mullooly: A really bad suggestion or idea because you are getting some of these investments at a terrific bargain.

Brendan: Don't think that can be stated enough. Especially considering if you make that decision, I think it starts to become like an addiction or a security blanket. It's like you're just building up this big money market or stable value or short term bond fund position and then you have to time the market. So instead of just having a systematic plan that's going to do it for you and keep you on track, maybe you've accumulated an entire of year of contributions in the money market now.

Now you have to decide how to handle a lump sum of money like that and I think that has much more regret associated with it than just systematically buying. And it can definitely feel like in the interim like you're throwing good money after bad, but that's certainly not what you're doing. You're averaging into these investments and like you said, you're buying them at lower prices which is in the net, going to help your returns in the future when these investments eventually do recover.

Tom Mullooly: Yep. Important to remember if you're investing for retirement. So that's going to wrap up episode number 237. Thanks Brendan for being prepared and coming to this with some great information that we can pass along to our listeners. And we look forward to catching up with you in episode number 238.