Buying Company Stock & Accelerated Mortgages - Transcript

Tom Mullooly: Welcome to the Mullooly Asset Management Podcast. This is episode number 242. Thanks for tuning in. This is Tom Mullooly and I'm here with Brendan Mullooly. Hello.

Brendan M.: Hello. So we have a handful of topics to talk about today. Not all from the same areas. So we're going to hop around a little bit. But I think that's fun. We'll start off with PG&E. This has been a crazy one, right? Especially for-

Tom Mullooly: We can't even blame this one on Erin Brockovich.

Brendan M.: No. But this story, I mean, the stock has dropped, I think 80% from its closing highs in September last year.

Tom Mullooly: I honestly can't believe it's not down more.

Brendan M.: Right, so this is Pacific Gas and Electric. This is a utility company that has been involved to some degree in these wildfires out in California.

Tom Mullooly: According to some people they have burned down half of California.

Brendan M.: Yeah. Obviously stock is reacting to that price. I saw something interesting today though, I know you did too, is out there on Twitter. So there was an article and it talked about how the PG&E 401(k) plan had about 6.6 billion in assets overall, and 11% of that was invested in the company stock.

Tom Mullooly: What in the world are people thinking? Now this wasn't the company that put their own stock in the plan. This is the employees.

Brendan M.: Yeah. In many cases, I guess, and this probably doesn't even include if there are other packages where people are getting stock. This is just the 401(k).

Tom Mullooly: Just the 401(k).

Brendan M.: There could be stock plans outside of this that I'm sure people invest directly into. Or maybe just own the stock outright, because people tend to think they have an inside clue, or better understanding of companies since they work at it, may be the case. I don't know.

Tom Mullooly: Or, you know they pay a good dividend, until they're bankrupt.

Brendan M.: One of my points was going to be that this is a utility company. Supposed to be safe, right?

Tom Mullooly: Right.

Brendan M.: Just, not that this happens every day, or even every year with utilities, but just goes to show that, they're still stocks. And they act like stocks even if most of the time they're considered lower volatility, they pay a dividend, they've been around forever, steady incomes, most of the time. I mean, this is obviously a once in a lifetime type thing, but these things tend to occur more than once in a lifetime when considered across a broad spectrum, it seems like.

Tom Mullooly: I don't want to hijack the story, but growing up on Loong Island in the '70s and '80s, and if any of our listeners around the area were there, you know the story of Long Island Lighting. Again, a utility that you would have found in every single electric utility mutual fund. Every single one of them. And it was terrific. And they were building the Shoreham Nuclear Power Plant, out on the North Fork of the island. Public response to the cost overruns, and the emergency exit plans, there really weren't any. "Get on the Expressway." It's already a parking lot.

There just became this growing opposition. The stock started faltering under a huge amount of debt, and they stopped paying the dividend. The stock eventually went to $2. They never declared bankruptcy. But these things do happen, and they happen in a harmful way if you have money tied up in these things.

Brendan M.: Yes. So, it is one thing to be an investor in this company, it's another thing to be an employee and a stock owner in the same company, and that is one of the biggest risks of when your company offers your own stock as an option within your investment plan in your 401(k). This is the danger in loading up in it, or even having much more than, I would say, five or ten percent as a rule of thumb, of your portfolio directly in the company stock.

Depending on how else you're exposed to it, I mean this is where your paycheck is coming from, and if something's impacting the stock price, not always, but there's a chance it's affecting the business bottom line, is what's affecting that too. So you could be running into bad times simultaneously. I would imagine that is most often the case.

Tom Mullooly: There's a lot fewer electric utilities around in the United States today than there were 30 years ago. I know, here in New Jersey, we have Jersey Central Power and Light. But that's a subsidiary of First Energy, which used to be called Ohio Energy. I mean it's a pretty big company. So we've seen a lot of mergers happen but there's going to be that risk. Not only when interest rates are moving up or down, that's going to have an impact on these dividend paying types of investments. But what happens when a stock like Pacific Gas and Electric is in a fund or an ETF?

Brendan M.: I actually looked, again, as we say all over the podcast, not a recommendation or anything, but I looked at the Vanguard Utilities ETF, VPU. This stock was 1.4% of that fund. Over the last year I used Koyfin charts to take a look at performance attribution, and over the last year, so that captures the bulk of this story and even a little more so, it contributed -360 basis points, and about 3.6% of negative performance to the fund overall. That's not to say that's insignificant, but when you're talking about diversification, there's degrees of it, and at one end of the spectrum there is owning a single company like Pacific Gas and Electric, like directly, you own that one stock. And then somewhere along the spectrum in the other direction, you run into a sector fund like a VPU. It owns hundreds of utilities in the US market. It mitigates some of that single company risk.

It doesn't speak to broader risk like it may be, like you said, impacted. All of the utilities may be impacted by something like interest rates or something more widespread that affects that space. This isn't to say that a sector ETF is that diversified, either. It's always compared to what? It's more diversified than a single stock, less diversified than-

Tom Mullooly: The overall market.

Brendan M.: ... the total stock market index, so the S&P 500.

Tom Mullooly: A utility ETF is still a niche ... It's still a sector.

Brendan M.: It's definitely a niche product still. It's pretty specialized in the sense that it only owns US utility companies. Yeah, I think you just want to think about how specific you want to and need to be when it comes to getting involved in companies and a lot of times, in 401(k)s they're not even offering stuff like sector funds. But it's crazy that they'll have a menu with no sector funds, but they'll have a bunch of large cap, mid cap, small cap, diversified basket, mutual funds, international stocks that are going to own thousands of companies across industries, very diversified in many cases.

Then alongside that, they're going to offer one option, that is the company's stock. Because I'm not sure the average person knows how much extra risk they're taking on by having a single stock in the portfolio...

Tom Mullooly: Even if it's a great stock.

Brendan M.: Yeah, don't get me wrong. It could totally pay off, and you'll hear all ... What'd you hear about in the '90s? The Microsoft millionaires, right?

Tom Mullooly: Sure.

Brendan M.: The people who were early at the company and hand tons of the stock, and it worked for them. That's great.

Tom Mullooly: Even people that worked for years and years and years at General Electric, at one of their locations around the country-

Brendan M.: Or even a place like Home Depot probably, people that were early on there that had a lot of company stock. It's tough to say you shouldn't own any of it at all.

Tom Mullooly: But let's go back to the GE story. How do you convince someone who's now 77 years old, they retired 12 years ago, so that would be 2007, and for the last 12 years, GE hasn't really kept up with whatever yard stick you want to use. But prior to that, holy moly, I mean that thing was fantastic. How do you convince someone A, you've got a significant part of your net worth, 20%, 30%, in-

Brendan M.: One company.

Tom Mullooly: ... GE stock. You have to do something.

Brendan M.: Right. That is really tough because I think that the urgency to diversify out of single company risk like that, what you're discussing, it only becomes urgent or important seemingly after the fact. Because it's harmless or even beneficial when things are working out. The problem is that, and I mean this is a great example with Pacific Gas and Electric, nobody foresaw a natural disaster like this occurring or something where they exacerbated the problem.

Tom Mullooly: That's why I was saying-

Brendan M.: If you can't tell me that that is not going to occur to your company specifically, then I think there's a good chance you should think about diversifying, even if it means in hindsight, that you diversify and leave some money on the table, because the stock does well. I think it's still a decision that without being able to predict the future, it's an intelligent one to make regardless of whether it costs you money or not.

Tom Mullooly: When we do bring this up in conversations, every now and then we'll have someone say, "Yeah, but Warren Buffett will have concentrated positions. He's done really well." My response would be, "He has the capital to do that. You've got limited capital and you have to live on it. You have to live on that money. Totally different set of circumstances."

Brendan M.: And also, and I mean I think this is true to this day and time, but Warren Buffett owns companies that he literally sits around reading through the financials of the company. Are you doing that work, or are you just using that as a reason why you too can own individual stocks? If you're not doing the requisite work to have opinions like he does about individual companies, and you don't have the luxury of not outliving your money being a valid concern, then I don't believe you're in a position to say things like that. You're not Warren Buffett, I'm not Warren Buffett, so there are plenty of good lessons to take away from him, but what's his quote on diversification? It's for people who don't know any better, whatever it is, right?

Tom Mullooly: I'm going to have to take your word on that.

Brendan M.: He said something along those lines. It's like, I know he wasn't the one who said put your eggs in one basket and watch that basket.

Tom Mullooly: Watch that basket.

Brendan M.: I don't know if that was him either, but there-

Tom Mullooly: I think Charlie Munger said that.

Brendan M.: Yeah, there are quotes from the duo that suggest diversification is for people who don't know better, or aren't smart or something along those lines. I'm not sure that that's helpful for the individual investor. I like some of their other hits a little better.

Tom Mullooly: I think the problem is that when we talk about Buffett and Munger and Bill Gates, I mean, they are billionaires. There is no risk that they're going to outlive their money, but for Mr. Jones who worked at GE, and has accumulated 800 or a million or $1.5 million, we can't screw around. We really need to diversify because we are diversifying away this kind of risk, like we had with Pacific Gas and Electric.

Brendan M.: Right. You're not diversifying to get rich. You're diversifying to make sure you don't get poor.

Tom Mullooly: Correct.

Brendan M.: That's the point with that, and it's not sexy and it is what it is, but yeah, agreed. There's a lesson here and a lot of these stories come out pretty often when an individual company gets rocked pretty hard. It seems to be always the case that we end up reading a story about how much people had in the company 401(k), directly in the company stock. Nobody learns this lesson, or it's one of those where we think, "Ugh, it's a great story about GE or the Pacific Gas and Electric folks, but that's never going to happen to me."

Tom Mullooly: Let's talk about mortgage…

Brendan M.: Yeah. My friend, our friend from Twitter-land, Justin Castelli, an advisor.

Tom Mullooly: Friend of the firm.

Brendan M.: Yes. He tweeted something this morning and it was talking about an ad that he saw on YouTube, and it was talking about basically how you can take your 30 year mortgage and this guy will teach you how to pay it off in seven years. Sounds pretty cool.

Tom Mullooly: Is it the same guy who has that book, I Will Teach You To Be Rich?

Brendan M.: I don't know. I'm not sure.

Tom Mullooly: I'll get rich teaching you how to be rich.

Brendan M.: Yeah, Justin tweeted out, "I saw this thing, is this for real? Is there any merit to it? Has anyone heard anything about this?" I shared an article with him from The White Coat Investor, another Twitter personality.

Tom Mullooly: Really well done.

Brendan M.: Yeah. It talks about this idea of mortgage acceleration which we've heard before. His post is really thorough and it's great, because it starts with the good version of mortgage acceleration, which is just if you have a 30 year mortgage, you can pretend it's a 15 year or whatever, and pay extra towards the principal each month, or on a pretty regular basis, to shorten the duration of your mortgage. It's basically just pay more money to your mortgage and that will accelerate the term, right?

Tom Mullooly: You know, the thing that I pointed out to Brendan before we turned the mics on, there's still people that pay their mortgage by check. You get the coupon, you get your statement every month and you fill out the check and you send it back in. Most mortgage companies have a line on your coupon that says, "Extra principal" with a blank. You can do it right there. But everybody, I shouldn't say everybody, but a lot of people are not conditioned to paying their mortgage online, it's a regular payment that goes out every month, they don't even think about it.

But like we have said with credit card debt, student loan debt, folks, that the minimum that they're asking for from you. Car loan, same thing. That payment, that is the minimum, you can always pay more. But there's a risk in paying too much and we'll get to that.

Brendan M.: Yeah, obviously going to be a little different for everybody, but we have some feelings about that, that I think it doesn't often, it's not the primary reason why people think about getting rid of the mortgage.

Tom Mullooly: This mortgage acceleration has now turned into a product which is unbelievable. I mean, if you have to sign your life away to something, or go to a closing to get into some kind of mortgage acceleration, someone's getting paid.

Brendan M.: Yeah. There's obviously incentive, probably for the mortgage broker, to suggest doing this, and it's a little bit elaborate. It probably sounds like really smart, too, and when you do things that are complicated and elaborate, it makes you feel smart as well, because it seems like there's some kind of game going on, like you're doing this for free or something or like that.

Tom Mullooly: You get the cocktail party opener that you can talk about.

Brendan M.: Yeah, it's great to tell people how smart you are when you do stuff like this.

Tom Mullooly: But is it really? Let's walk through some of the mechanics of this.

Brendan M.: Yeah. This idea of mortgage acceleration refers to using a home equity line of credit.

Tom Mullooly: Red flags going off already.

Brendan M.: Yeah. You're going to take out a home equity line of credit, and you use the home equity line of credit to pay down some of the principal on your mortgage, in whatever amount makes sense. Point being that your mortgage maybe goes from being $400,000, remaining in principal, to $300,000, and the same with payment.

Tom Mullooly: With 100,000 in home equity.

Brendan M.: Yeah, if you take out 100,000 to do it that way. I don't know. There's a couple of things that need to break right for it this way. Basically, the way that this is suggested is you're using the home equity line of credit, moving forward from that point, as your checking account.

Tom Mullooly: Substitute checking account.

Brendan M.: Yeah, you want everything flowing into and out of the home equity line of credit, so that over time, general just to boil it down, go check out the post if you want the nitty gritty of things here, but if you spend less than what you earn on a monthly basis, and all of the money is flowing into there, you're basically coming up with a painless way to not have to think about it, but you're slowly chipping away extra.

Like, you're paying your regular mortgage payment, and let's say each month you run a surplus of $700. Every month, it's as if $700 is going to also pay down the mortgage and also eliminate some of this debt. A lot of it is predicated upon interest rates being favorable to you, which may not be the case, home equity line of credit is a variable rate of interest.

Tom Mullooly: But this could actually work. The way to thread the needle in this is you have to be spending less than what you're bringing in, which is kind of fluky in the United States today.

Brendan M.: Well also, a good point is that if you're doing that, then there's nothing stopping you from taking that extra money at the end of the month and just filling in the box on the form like you said, and sending it towards the principal of your mortgage.

Tom Mullooly: But there are so many things, you and I had a field day talking about this before we turned the mics on. Let's just run through a couple of the highlights on this. I'll start. The first thing is, home equity loan is variable rate loan. If The Fed's raising rates, your costs is going up. Costs are going up all the time.

Brendan M.: Also, at any point in time, the bank could decide that there is no more home equity line of credit.

Tom Mullooly: 2007. We had a home equity line in 2005, 2007 I got a letter from the bank saying, "This line's being cut off. Whatever you've used, you'll have to pay back, but no more. It's gone."

Brendan M.: Right. In most cases, getting the carpet pulled out from underneath you, so to speak, is going to happen probably when you can least afford to have liquidity taken away from you, because banks are going to do stuff like that when the economy isn't great. If the economy's not great, then I mean, is your job not feeling it? You're probably feeling it in some way, whether it's salary or job being threatened, not good times for anybody when the economy's doing poorly.

Tom Mullooly: What Brendan's point is that it's not going to be just one bank who decides to call in your loan. It's going to be all banks at the same time are going to be cutting them off the way they did in 2007. But there's something else that morally you need to be aware of. What is a home equity line of credit for? It's for making improvements on your home. If you're using your home equity as a substitute checking account, you're not using it as what it's intended for.

Brendan M.: Yeah. There may be some tax implications to mingling these funds. These are borrowed funds from a home equity line of credit, getting mixed up with all of your other monthly cash inflows and outflows. That may impact the deductibility of this expense, especially with some of the new rules that have come out with the new tax law.

It seems like there's going to be more tightening on that, but this has been an issue before that at all. You wouldn't have wanted to mix up these funds together anyway. I think the big one is if you're going to do this and then breakeven or spend more than you're bringing in each month anyway, I think that like you had said, you're just going to be using the home equity line of credit as a piggy bank, and it's not actually going to be doing anything for you in terms of making the mortgage go away any faster.

Tom Mullooly: On a related note, have you heard, you're not my age, so have you heard of anyone having a mortgage burning party?

Brendan M.: No. Can't say that I have.

Tom Mullooly: That actually used to be a popular thing.

Brendan M.: Yeah?

Tom Mullooly: Yeah. I remember when my parents had their mortgage burning party, and they invited everybody up and down the street to come over. They had a party and they burned the mortgage. They put it in an ashtray, and they actually lit it on fire. They burned it, and everybody had a good time. Because it was a big accomplishment that they had completed paying the bank and the house was actually theirs. As other neighbors would have mortgage burning parties, it was a rite of passage in the neighborhood. People don't do that anymore, because they're not taking 20 years to pay off a mortgage. They're flipping their house, and then that mortgage gets resolved and they move into a new house and they start another mortgage.

Brendan M.: We hear a lot though, paying off the mortgage is something I think people aspire to two things when it comes to a house. They aspire to own a home, like the American dream, and then they aspire to actually own the home. They want to buy their home and then they want to own it outright, because it feels good not to have this big debt hanging over your head anymore.

But one of the other points in this article from The White Coat Investor was just that before you pay anything extra towards your mortgage, you should definitely be maximizing retirement accounts first, for the tax break that you're going to get, and secondarily, a thing that pops into my mind is, if you reach retirement and instead of maximizing your tax deferred retirement savings that you have available to you, you were paying extra to the mortgage the entire time, and maybe you have less in your 401(k) or IRAs at that point, it's going to be great to not have a mortgage.

Maybe it'll be as simple as that and you'll have a small footprint because of that. That is one of the biggest expenses we see when people are coming in, but you're also not going to have as much liquidity as somebody who maybe still has a little bit left on their mortgage to pay but has a pretty big 401(k) balance that has been compounding for decades, working for them, probably at a higher rate of return than what the house is going to earn.

It's available to them, like you can go to your IRA, or 401(k), or brokerage account even, and take a distribution from that to pay for living expenses in retirement, or at a moment's notice, when there is a medical emergency or something along those lines, you can borrow from the value of your home, but it's not always guaranteed, as we've discussed. I mean, sometimes you're not going to be able to get a home equity line of credit if you need it, depending on the situation, or you might have to take something like a reverse mortgage, and I don't know how people feel about that.

It can be right in some instances, but it's not the same as just pulling money from an investment account.

Tom Mullooly: This whole mortgage mess is still fresh in a lot of people's minds. 2008-2009, and even into 2010, there was no access to getting a mortgage. Forget about a cash out mortgage. Mortgage where you actually put money in your pocket. I mean, that has just reappeared in the last couple of years, but I think the memory is still fresh in everyone's minds, or should be, that your house is not a piggy bank. It shouldn't be looked at that way, and we were talking, we were just comparing some notes about we bought this house in 1995, and for the first 10 years that we were in the house, I mean, it looked like a terrific investment.

But it's not an investment. It's really not. It just happened to appreciate during that period of time. For the next 10 years, from '96 through 2006, it also increased. I mean, that was the original period. From 2006 through 2016, I'm going to guess we probably had negative growth for at least a portion of that time, where it was flat.

Brendan M.: It's averaged to something in between, but your point being that homes are not investments, nor should you anticipate them appreciating at some rate of return that is going to make you wealthy or something along those lines. It should primarily be a place where you live and again, nothing wrong with aspiring to get rid of debt in the mortgage, but to be myopically focused on just doing that, without considering the context or where that will put you, if you only focus on that, I think may be foolish for some people. If you have ample liquidity elsewhere, and it'll give you good peace of mind to pay off the mortgage, then great. If you're not going to be restricting yourself at all, but if you're going to be extremely unliquid-

Tom Mullooly: Not a good idea.

Brendan M.: ... but you also don't have a mortgage, it's like, "Wow." I mean, to access that, you're either borrowing against the value of it, you're selling it. I mean, is that your idea of-

Tom Mullooly: There's no other way to raise money from an illiquid asset.

Brendan M.: Right. You're not liquidating 4% of your home each year to live off of, like an IRA or something, right?

Tom Mullooly: People were in a hurry years ago when they had 11, 13, 15% mortgages. I've seen some people with those kind of mortgages, it's unheard of today. When you have mortgage rates like that, it makes a lot of sense to focus on paying down as much as you can and reduce the amount of interest that you're paying. But we've gone through a huge wave of refinancing over the last couple of years, and there's a lot of people who are now paying-

Brendan M.: Three, four, five.

Tom Mullooly: ... 2.78%, 3%, 4%. Historically, anything under 5% is a really good mortgage rate. Historically speaking. I don't know if I would necessarily be in a hurry to pay that off anyway, if I've got a 3%, 4% mortgage. It's a good deal.

Brendan M.: That's why this has got to be, obviously unsatisfying answer, but it has to be case by case. Because for some people, it may be right to get rid of that debt. For others, there may be bigger fish to fry so to speak, in terms of where they should be channeling their resources and focusing, at least at the present time.

Tom Mullooly: Two good topics in episode 242. Thanks for tuning in and we will catch up with you next time.