Lessons From Market Crashes - Transcript

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Tom Mullooly: Welcome to the Mullooly Asset Management Podcast. This is Episode 262. Thanks for tuning in.
This is Tom Mullooly and with me, my co-host this week, Tim Mullooly.

Tim Mullooly: Hey everybody. How's it going? This week, we have-

Tom Mullooly: You know you're asking a question that they can't actually answer?

Tim Mullooly: That's okay. It's a rhetorical, "How's it going?"

Tom Mullooly: Okay.

Tim Mullooly: Well, anyway-

Tom Mullooly: Tim, how's it going?

Tim Mullooly: It's going good, it's going good. We've got one article that we wanted to talk about today by Jonathan Clements.

Tom Mullooly: Friend of the firm.

Tim Mullooly: Yes, he was a past guest on my podcast, Living With Money.

Tom Mullooly: That's right.

Tim Mullooly: We'll link to that, if you want to listen to it.

Tom Mullooly: That was a very good podcast, and that was actually one of the first episodes.

Tim Mullooly: Yeah, it was very early on in the show. It was definitely a very fun interview. I mean, Jonathan's been writing for The Wall Street Journal, and Forbes, and has, I think, nine books out right now. He's got a ton of work you could go check out.

But he wrote an article on TheEvidenceBasedInvestor.com, and it was called, What I Learned From Five Crashes. He outlined five different times that the market essentially crashed during his career, and I noticed that they kind of lined up with five crashes that happened during your career too, Tom, so I figured it was a good idea. We can talk about his points and then I can also ask you about your own personal experience during these times.

Tom Mullooly: Sure.

Tim Mullooly: The first one that he talked about was Black Monday, which was October 19, 1987.

Tom Mullooly: Right.

Tim Mullooly: It said he was 24-years-old, and I think you were-

Tom Mullooly: I was also 24.

Tim Mullooly: Right, yeah.

Tom Mullooly: That's pretty amazing.

Tim Mullooly: On that day, you saw the S&P 500 drop 20.5%. Jonathan said, he wrote that, "Black Monday was a classic example of why you shouldn't panic during periods of market mayhem. Those who dumped their shares got out of the market at the low or close to it." What was your experience like with Black Monday in 1987, and what was a big lesson that you took away from that day?

Tom Mullooly: Castles don't grow to the sky. Very interesting. At the beginning of 1987, we were hitting a new high. In January, we hit a new high every week, and we were hitting these hundred-point marks on the Dow. In January, I think we hit 1900, and then we hit 2000, and 2100, 2200. I think we peaked around August and it was 2700. Until that time, the market, I think, had one or two down weeks through almost eight months.

It was one of those goofy things in that the market went up. It seemed like the market went up every day, but it didn't go up a lot; it just went up every day. We'd have the occasional down day and we'd be like, "What's wrong? There must be something wrong with the world because the market went down today."

Tim Mullooly: Right.

Tom Mullooly: And then we had a huge crack. A couple of things went on. We actually had, one of the down days that we had was in April. Bond market really had their own crash in April of 1987. Nobody writes about that. We saw interest rates spike. I'll get back to that in a second. Interest rates went up steadily throughout the summer, and the market continued to go up. That normally doesn't happen, but things aren't normal on Wall Street.

We had a big crack in April, and then August, we had another crack, and then September, the market went down almost every single day. It felt like it went down every day. Interesting to note: the Dow Jones, on the day of the crash, was down 508 points. That was 22%. The Friday before that was option expiration day. It was October 16th. The Dow Jones was down 109 points. It was the very first time that the Dow Jones went down 100 points.

Tim Mullooly: Wow. I mean, put that into perspective. How many times this year alone in 2019 has the Dow gone up and down 100 points in a day or in an hour?

Tom Mullooly: Yeah.

Tim Mullooly: He also wrote that the people who sold their shares got out, like I said, at market low or close to it. You think back, it was 1987, news didn't travel as fast as it did in 2019, so by the time it reached individual investors, potential clients that you had, they were calling up at the end of the day-

Tom Mullooly: Yes, they were.

Tim Mullooly: Or even the next day or the day after that, and the market was still trying to recover, and process everything that happened, and people were just sending in sell orders like crazy, right?

Tom Mullooly: It's interesting how the market started sliding right from the get-go. The overseas markets were bad, and it continued right through the New York Stock Exchange opening at 9:30. The market continued to go down. I started getting phone calls, the market closed at 4:00 like it does now, I started getting phone calls from people around 1:30. "The world's ending!"

Tim Mullooly: Yeah.

Tom Mullooly: I had a woman call. She had money for her three kids for college in custodial accounts. She called me at 3:00 on that day, and she said, "I want you to sell everything that's in those three accounts for my kids because we need this money to go to college." She was clearly panicking, as were other people during the day. I remember telling her the tape is so far behind.

Now, the tape, you used to be able to just type in, "Tape," T-A-P-E, and it would tell you how far the tape was behind. We actually had one of those scrolling things that you see on TV.

Tim Mullooly: Right. Yeah, with the symbols. Yeah.

Tom Mullooly: Yeah, we had that in the office.

Tim Mullooly: Right.

Tom Mullooly: And so you could type in, "Tape," and see how far behind the tape was. The tape was, at 4:00 that day, the tape was three hours behind.

Tim Mullooly: Oh my god.

Tom Mullooly: So yeah, you would put in a trade at 1:00, it would be reported at 4:00 or 4:15. There was no way of knowing what kind of price you were going to get that day. That didn't stop people from calling in saying-

Tim Mullooly: They just said, "I don't care. Just get me out."

Tom Mullooly: "I don't care. Just get me out at any price."

Tim Mullooly: Jeez.

Tom Mullooly: I was two years into the business as a broker, and that really set the tone for when the markets go down, it doesn't happen very often, but sometimes I still hear the tone in people's voices where they're like, "Get me out at any price. I don't care." It's frightening when you hear it.

Tim Mullooly: The other point that Jonathan made too was that commentators for the next couple of months were talking about a recession that was coming, and how the economy was going into a recession, potentially depression, and it never came. He was saying, "Anyone who listened to them missed a great opportunity to buy stocks again at bargain prices," because what happened in the coming months after Black Monday?

Tom Mullooly: The market didn't recover right away.

Tim Mullooly: Right.

Tom Mullooly: In fact, there was a very good story that was in The Wall Street Journal a couple of months, actually, like two years later, that showed how the trading in the OEX options, now, that's the S&P 100, which have been pretty much ignored, they noticed that on Tuesday, they were trying to get the markets back on their feet and it just wasn't happening. Between Tuesday and Wednesday, there was a lot of trading in the OEX options to try and get them to trade back to parity levels. That actually kicked off a really good rally on Wednesday of that week.

The problem is when something happens, like you get a 20% haircut in one day, nobody's coming back. It's going to take a long time. It wasn't until October of 1989, two years later, that the market had finally gotten back to where it was pre-crash. The rest of the year, the market kind of meandered. Believe it or not, we finished up for the year, but the market was up in August. Before the crash, the market was up 27%; we lost 22% on the Dow in one day; we finished the year just kind of treading water, so we finished the year up 5%, and you would never know it.

Tim Mullooly: Yeah, it's remarkable.

Tom Mullooly: Yeah, a lot of action. Looks like nothing happened at all.

Tim Mullooly: Yeah, it's almost like the what if, hey, if you fell asleep in January and woke up in the next January-

Tom Mullooly: The Rip Van Winkle-

Tim Mullooly: Right.

Tom Mullooly: Right.

Tim Mullooly: You would have been like, "Eh, it was an okay year."

Tom Mullooly: Yeah. It was very scary because there were a lot of people in the office that I worked who had been brokers for ... I worked in a very old office, a lot of old brokers, and guys who were walking around saying, "This is worse than 1962," and I'm like, "That's the year I was born. I don't even know what you're talking about." "The way this happened, this was worse than '73, '74." I'm like, "Look, I know it was bad, but come on," you know? These are guys that had lived through all of these things, and they're at the tail-end of their career, I'm just starting mine, and I was like ... You know what? It was a great lesson for me to see now, looking back, and saying, "Gosh, that really turned out to be a great opportunity to buy, but no one was going to do it.' No one was going to do it.

The other thing that I wanted to just circle back to, I mentioned earlier a moment ago that the bond market had cracked in April. April, if you look at what happened in April and May of 1987 in the bond market, yields spiked, and so people who were in bond funds got destroyed. I mean, crushed! You buy these things for safety. A lot of bond investors were very unhappy because interest rates started moving up suddenly.

The Friday before the stock market crashed, so October 16, 1987, you could buy a zero-coupon Treasury bond yielding 10%.

Tim Mullooly: Wow.

Tom Mullooly: Yeah, 10%. That's when, I think the final shift came that it was like, "Hey, I can move money into something that's guaranteed by the US government. I'm going to 10%." There's a lot of reasons why, but that was something that was pointed out to me.

Tim Mullooly: Yeah. The next crash that Jonathan wrote about was he called it "The tech wreck." That was in the late '90s, the tech stock boom. He said, "I suspect that, for many, their lack of understanding actually fueled their desire to buy." He said, "If it's confusing, it's got to be clever–and lucrative." That was kind of people's mindsets surrounding these tech stocks, these dot-com companies that they knew nothing about, but for some reason, the more confusing and the less they knew about it, the more they wanted to buy it, and drove the share prices higher and higher.

Tom Mullooly: That's so well-said because what Wall Street analysts were trying to get everyone to do was to focus on the clicks. They used to call them eyeballs. How can you get people to stay on your website? That's what's going to, eventually, bring transactions to your website.

In 1998 and 1999, people weren't buying things online with a credit card. That just did not happen. So these ideas were all great, good concept ideas, even Pets.com, really great idea, but just poor execution and everything got ahead of itself.

What I think a lot of people miss, Nasdaq Index right now – we're recording this in June of 2019 – Nasdaq Index is at 8000. October of 1999, that Nasdaq Index was 2500. Three months later, in January 2000, the Nasdaq Index was 5000. This thing was-

Tim Mullooly: It shows the magnitude of what happened.

Tom Mullooly: Yeah, this was a rocket ship and it crashed and burned. It was a supernova because it was brilliant for a few seconds, and then it just melted, and that's exactly what happened. We had companies, it was priced at $40 a share, it opened at $250 a share. Yeah, like six months later, it was $1, and then went to bankruptcy.

One of the high-flying stocks at the time was Priceline. Priceline, I can't even remember how high it went, but I can tell you that it went to $1 per share. Now you look at Priceline, it's one of the most expensive stocks out there.

Tim Mullooly: Right.

Tom Mullooly: You could have bought Amazon all day long for $27 bucks. Nobody wanted these things. They threw them all away, but it's easy in hindsight to look back at these things, but I think what really bothered me the most, being a commissioned stock broker at the time, was we had allocated clients' investments.

They had some money, a little money in growth. They would come in for their account reviews in 1999 and 2000 and they're like, "I see this dot-com fund or this technology fund went up like 80% last year. Why didn't we have that?"

They all started piling money in. "I want to get rid of this short-term bond fund that's paying 6%." 6%, short-term bond fund. "I want to get out of this short-term bond fund that's paying 6% and go into this technology fund, this dot-com fund, because it went up 80% last year," and it went down 50% the next 12 months.

Tim Mullooly: Yeah. The greed there just takes over and everyone just gets blinded by it. As you were saying that, it's almost like a direct contrast to what happened in 1987. The people got blinded by their fear on the downside and just said, "Sell, I don't care. I don't want to understand what's going on. Just get me out."

Tom Mullooly: Right.

Tim Mullooly: And in the late 1990s, 1999, it was the opposite, to the upside. "I don't care what this company does. I don't need to understand it. It's going up so much. Just buy it for me." That's crazy.

Tom Mullooly: That was really, also, around that time was the explosion of CNBC.

Tim Mullooly: Okay.

Tom Mullooly: And all of the online traders. You had E*TRADE and some of these other places really taking off. Ameritrade was advertising like crazy, E*TRADE was too.

Tim Mullooly: So everyone was a genius.

Tom Mullooly: Yeah! I had this client named Jane who would call me up. She'd call at like 8:00 in the morning saying, "We need to be in Expedia today," or, "Did you see that earnings report on XYZ?" That's when I started realizing that this is getting out of control because we could buy these stocks, and they would go up four, five, seven points a day on nothing, on no news, nothing. I'm like, "This is not a solid plan. This is not how we invest. This is just trading and this insane, the volatility that we have in these individual stocks." It was crazy to see.

And then for as right as you were on the way up, you couldn't be more wrong. I remember walking around the office. I can even tell you the date. It was January 4, 2000. Lucent went down for the first time ever, the stock went down 19 points. It was like a $75 stock. This thing, Lucent, had made a lot of people rich here in Monmouth County. This was the old Bell Labs, now renamed Lucent. They had their first really bad earnings report and the stock went from like $76 or $77 down into the $50s.

I remember showing people the chart on this. I said, "The next stop on the bus is $19 bucks." You would have thought I was lighting someone's momma on fire because people were like, "Get that stuff out of my way because that can't be true. This is going to be the best opportunity to buy this stock ever." The stock went to, basically, it went to $0.

Tim Mullooly: The largest takeaway for people today is just being able to understand what your investments are. General rule of thumb, I feel like, and Jonathan said it too, it's the opposite of it's confusing and clever, it's got to be lucrative.

Tom Mullooly: Right.

Tim Mullooly: It's usually the opposite. The simpler, more easy to understand, the better.

Tom Mullooly: Yeah. Makes so much sense.

Tim Mullooly: The third crash that Jonathan talked about was the housing bust. He wrote, "Even now, I find it flabbergasting that the housing bubble could follow so quickly after the tech stock bubble. Did folks learn nothing?" The tech stock bubble affected a lot of people, but the housing bubble affected even more because he said, "At the time, barely half of Americans owned stocks, while almost seven out ten owned their home."

Tom Mullooly: I'm going to give you a narrative on this because this is somewhere where I might disagree slightly. Yes, tech stocks started going down at the beginning of 2000. March of

2000 was the high water mark for Nasdaq. By 2005, the real estate market was just ripping higher. People were making money in houses like never, ever before.

But just think about this: if you had money in the stock market, or investing, or venture capital, or your own tech company like Lucent, if you saw that bubble burst, are you going to go back to the stock market? No way. "You know what? My home's always been a good value. I'm going to start to pay down my mortgage.

I'm going to fix up my house. I'm going to do this, that, and the other thing. I'm going to flip this house because I know how to hammer a nail and I don't understand how stocks work."

So, I actually am not surprised that housing became inflated immediately after all this money came gushing out of the stock market in 2001 and 2002. We had just gone through this recession in 2002, which was a lot worse than people write about, and so I'm not surprised that people said, "Hey, we're going to have," this is where the term staycation came up, and people said, "I'm going to fix up my house, or I'm going to invest in this other property and rent it out, I'm going to become a real estate wizard. I went from being a technology wizard, day trader, to real estate wizard, house flipper."

We had low interest rates, plenty of money, the banks were extremely accommodating because you could have a drive-by appraisal. We refinanced our house and we were asked, "What do you want the house to appraise at?" That was literally the question the mortgage guy asked. "What do you want the house to appraise at?"

Tim Mullooly: Yeah. Some of the points that Jonathan said was how you expect stocks to be risky, but you don't expect your house to be a risky asset. He said, "Unless you buy stocks on margin, you can lose what you put into the stock, but you can't lose much else than that." But unless you buy your house with cash, all houses are purchased with leverage and on mortgages, and that's just the way it is, but you never expect it to have the bottom fall out like they did.

Tom Mullooly: Well, a couple of things helped exaggerate the situation. We had a lot of people who could buy houses. There was a lot of mortgage fraud going on where people were just making up numbers and they didn't need documentation. There were a lot of people who bought with very little equity. There were people who bought homes with no money down, so they had no equity, 100% leverage.

When you buy a house, you are 5:1 levered because you put 20% down. Well, I guess it's 4:1. You are leveraging the remaining 80% against your 20%. Okay?

Sometimes people don't have 20%, so they put down 10%, and they've got to pay additional insurance and costs for things like that. When you get people who are buying these properties, and sometimes flipping them, with 0% down, 3.5% down, 5% down, they're really maximizing their leverage.

The leverage is great when things are going up; leverage is a quick trip to hell when things are going down. It doesn't take much of a drop in the price for you to basically have a margin call. That's pretty much what happened to a lot of people.

Tim Mullooly: I feel like with the housing burst that he was talking about, to me, like he said, you expect stocks to be risky, you don't expect your house to be risky like that. I think it's just a good reminder that even what's the most safe asset in your mind, still, there's risk there. There's always risk with whatever type of investment you have, whether it's real estate, gold, gold bars, stocks, bonds, anything. There's always risk.

Tom Mullooly: Yeah. And the problem is with something like real estate, it's an unlisted security. It doesn't trade every day.

Tim Mullooly: Yeah. It's illiquid.

Tom Mullooly: It's totally a liquid. You're not going to know the value of that house until your neighbor or someone on your street sells their house, and then you get a ballpark idea of what your home could be worth.

Tim Mullooly: Right, could. That's just a ballpark.

Tom Mullooly: Still, what someone's going to pay for your house is the price.

Tim Mullooly: That's the market for you.

Tom Mullooly: That is the price.

Tim Mullooly: Yeah. The next one he talked about was the Great Recession, which was the recession that followed the housing market bursting. Even still, as much as the market went down then, and there was a recession in the economy, he said, "Still, it was a good opportunity to buy stocks." He said, "At the time, it seems like the most naïve of strategies, but what's the alternative?"

Tom Mullooly: It's interesting to see that, in the 1940s and '50s, there was a huge drive in this country on heavy manufacturing. We built railroads, we built railroad cars; we built an entire industry around railroads, trucking, shipping. All right? In the '40s and '50s. In the '60s and into the '70s, it was cars. Okay? Into the '80s, it was hardware and software. Okay? What did we make in the '90s and in the 2000s? What was the prime business on the manufacturing side in the United States? Homes. It was housing.

So you look at this and say we go through these cycles where we had heavy industrial, then we went into recreational, then we went into technology, now we're into homes. That was the business. The banks will basically finance the business of industry. So the banks' business, for the '90s and into the 2000s, was financing homes, real estate. Okay? Every bank was a partner with you in the real estate business. Understand that we had this housing bust, and then we had this great recession. We had the housing bust followed by a slowdown in the economy. One kind of led the other.

Here's where things really went off the rails, and this is why people get so wrapped up and nervous about the next recession, but not all recessions are created equal. We can have slowdowns in the economy, and even period where we have negative growth. It's not that harmful. What really hurt the economy, more than anything else, during this Great Recession, which is an awful term because there was nothing great about it, was in addition to an economic slowdown, a recession, which happens periodically, a lot of banks failed. In fact, most banks were technically insolvent and they needed a bailout. That's what made it worse. I can't say most, but there were many, many big banks that were teetering on the brink of closing, which would have been far, far worse than what we lived through with TARP and all this other nonsense that we went through.

So it was, yes, a recession, plus the banking industry was technically insolvent. We've written quite a bit on our website about these mark-to-market accounting changes, which basically drove all of the mortgage lenders in 2007 out of business. Mark-to-market means that every day, you have to reprice your balance sheet.

If you and I are competitors in the banking business, and you have a loan that craps out, you've got to mark that loan down today to zero. Okay? But it also means that all the other loans that I'm holding across the street, as a competitor, they all get marked down too because there's a risk.

So mark-to-market means every day, we had to basically reprice our balance sheet. Some of these loans, we plan on holding for 25, 30 years. Didn't matter. The new accounting rules said you have to reflect mark-to-market accounting. These mortgage companies went to zero overnight, and then the banks followed right behind that.

It's interesting, if you look at when the SEC ... It wasn't the SEC. But when mark-to-market accounting was suspended, stock market turned around. I believe it was March 7th or March 11th of 2009. It was within 48 hours of the bottom in the market. When those mark-to-market accounting laws were suspended, banks started going right up, market came right back.

Tim Mullooly: There's been a handful of these crashes over the last 30 plus years. What would you say is one large takeaway that you could take from all of them?

Tom Mullooly: You can't have a bust without a boom. There's going to be a boom before. Enjoy it. But you know, you've heard me say this, you must be tired of hearing me say it: it wasn't raining when Noah built the arc.

Tim Mullooly: Right.

Tom Mullooly: You know what? There's going to be some rain. You better be prepared.

Tim Mullooly: Yeah. That's going to wrap up our conversation for Episode 262 of the Mullooly Asset Management Podcast. Thanks for listening and we'll see you on the next one.