Don't Go Chasing Interest Rates - Transcript

Tom: Welcome to the Mullooly Asset Management podcast. This is episode number 264. I am one of your co-hosts, Tom Mullooly, and along with me is Brendan Mullooly.

Brendan: Yeah, so yesterday we had a car parked on our front lawn at the office here, which is interesting, just figured I'd throw that out there at the onset.

Tom: The cops came in around 6:15, we heard the alarm go off when they came in, and that was totally unexpected. They said, "Do you know this person's name, or do you know why that car is parked on the lawn in front of your office?"

Brendan: We were like, "What the heck are you talking about?"

Tom: Of course the first thing I said was, "Did it hit our sign?"

Brendan: Yeah, obviously priorities. Yeah so, this thing was just out there on the front lawn.

Tom: I actually snapped a picture with my phone, I wonder if we should put it in with the-

Brendan: Put it in the show notes?

Tom: ... in the show notes, yeah.

Brendan: Anyway, that was-

Tom: If you own the brown Camry, please come back and get it.

Brendan: Yeah. So, that was end of day excitement yesterday. But anyway, plenty to discuss on the podcast today.

Tom: We have 8 trillion things to talk about on the podcast today.

Brendan: Yeah, we'll lead off with a nice post from our friend Ben Carlson.

Tom: Friend of the show.

Brendan: Yes. So, he had a post last week, it was called Interest Rate Chasing in Your Savings Account, and he had some interesting stats in there. He says that over $8 trillion are sitting in bank savings accounts that pay less than 0.1% interest.

Tom: That's 0.1%, not 1%. It's 0.1%. It's one tenth of 1%. Now, back in the day, this was a full time job for folks who were retired. They would go from one bank across the street to the other as their CDs came due, and they would drive around town, sometimes for three days, looking for a bank that would give them a higher yield than what they just came out of on a CD. So this was big business for a lot of folks.

Brendan: That's kind of ... Ben was talking about that too, the new version of that is shopping around online at these different online savings banks, because if you are at a bank paying something like 0.1% on your savings you are missing out, because there are many, many banks out there now, mostly online banks, offering something in the realm of 2% on online savings accounts.

So, similar to CD shopping, you can look online at a million different places, and maybe pickup and go from one bank to the other over 0.1% or 0.2%. The overarching theme of Ben's post was to not spend time doing that, because there's probably enough people out there that can make that jump from 0.1% at their brick and mortar savings bank locally, or wherever they do it, to something like 2% at an online bank. So, to worry about that jump from essentially nothing to 2%, rather than worrying about 2% versus 2.1% versus 2.2%.

Tom: Yeah, that's not really going to move the needle for most people, as you said. Going from 2.1% to 2.2% isn't really going to, but if you're going to have money parked, it's moving from 0.1% to 2.1% can actually make a difference.

Brendan: Well let's ... So, on the entire number, the $8 trillion, if you assume it's earning 0.1% and that it could earn let's say 2.1% just to use a 2% gap, that's $160 billion in profits that these banks are keeping for themselves, because short term interest rates say that they should be paying something like 2.1%, and they're pocketing that to profit off of people who have inertia or don't want to move to somewhere different to get better interest.

Tom: It's $160 billion, with a B, I don't want to sound like Dr Evil, but $160 billion that you're just giving to the banks. This is money that's sitting in savings accounts. Brendan, what's stopping a lot of people from taking advantage of something like this?

Brendan: The biggest apprehension that we normally hear to keeping your nest egg, your emergency fund, safety money, in something like an online bank instead of a brick and mortar bank is just that, is that you feel better having a bank branch that you can physically visit, or you can see when you're driving pass it around town.

I get that, and I think that if that peace of mind is worth the 2% or so interest that you're giving up on your savings, that's totally fine. I think that if that's how you feel, that's okay. What irks me a little bit is the people who lament the low savings rate at their bank and then are presented with an alternative to get far better interest, and still don't want to do it, but still want the ... They're like, "Well no, I don't want to change banks. I just want more money." It's like, "Well here's how you can do it."

Tom: Here's how.

Brendan: It's an either or kind of thing. So either you get your brick and mortar, I can drive to my bank today, or you can have higher interest. One or the other.

Tom: So it's really on them when they have the opportunity before them, I understand that someone who's 85 years old, they grew up through the depression, they're born in the 1930s, and so their life has been molded in a different way than you and I. But for folks that are not 85, for folks who are 40, 50, 60, there's no reason why they can't look at it. It's funny, when these online banks started showing up, some of them have been around nearly 20 years, at least 15 years, the first thing I thought of was, "Well, they don't have bank branches, so that's going to save the money."

Sure enough, they actually turned that into part of their marketing appeal is that they don't have bank branches, they don't have late hours. For goodness sakes, they're open 24/seven, they're on the internet. They don't have to pay tellers. They don't have drive up windows that have to be repaired. They don't have a lot of things, but they have convenience. When you look at it from the other side of the ledger from a bank that's got physical locations, they do have all of those assets that they have to maintain, and they do have all the staff that they have to pay benefits, salaries, all of that. It's no wonder that these banks with physical locations, they can't pay 2.1%, or two point whatever-

Brendan: Right, they need to spread on that to pay the bills.

Tom: That's how they pay the bills.

Brendan: Right. Totally get it, and it's understandable. A final thing that I think I'll add is that these online banks are FTSE insured, just like a physical bank branch would be when you have an account there, and additional food for thought, it's not as if your physical bank branch has your money sitting in a vault there.

You can't go Scrooge McDuck into your money at your physical bank branch either. They have a fraction of the total deposits at the branch actually there in cash ready to be paid out.

Tom: And it's a low percentage.

Brendan: Yeah, they loan it out, that their .... Their primary business is-

Tom: Lending.

Brendan: ... loaning. Yeah, the money's not there either, but I ... Look, I can totally understand the idea of an online bank just being a step too far. It's like, "Yes, I know that the bank doesn't have my money, but it's still there. It's a brick building. It's an institution." So, I get it.

Tom: But in defense of the physical banks though, they can't do this because they have all these other expenses that they've got to pay. Now, having said all of this, Ben's article kicked off with an email that he received. I think he got a notice from Marcus?

Brendan: Yeah, so that's, and ... So, another thing about these online banks is that a lot of them are divisions of banks with bigger physical locations, like Marcus is an arm of Goldman Sachs-

Tom: And Ally, that was actually carved out of General Motors Financing.

Brendan: Did not know that.

Tom: GMAC.

Brendan: Interesting.

Tom: That's where it came from.

Brendan: Okay.

Tom: Yeah, they're subsidiaries of some much, much bigger companies. But, Ben kicked off his article, because he got a notice that the rate that he's going to earn on his idle cash is going down.

Brendan: Yeah, I think it went from 2.2% to 2.1% or something in that ballpark.

Tom: This is the really goofy part, and I don't want to get into forecasting rates or anything like that, but there's rumors galore that the Fed at some point in the near future may be looking at cutting rates. So, those rates may be dropping. In fact, the yield on the 10 year treasury today is under 2%. I can't see paying on idle cash yielding more than what you would get on a short term T-bill, or something like that. So, If those rates move down, you can bet that at some point in the future, all of the banks are going to need to adjust their rates as yields move all the time. It's not a locked in rate.

Brendan: No.

Tom: It's going to stay ultra competitive. I think there's a lot of benefits to it, if you can get past the idea that there's not a bank on the corner with a free toaster.

Brendan: Right, free toaster. There's always going to be some kind of a premium there, whether it's half a percent, or 1%, or 2%, obviously that is up to what interest rates are doing at large. If you are looking for a way to earn something extra than what you're getting at a standard bank without ... You're not taking any more risk by doing this, so it really is free money in the sense ... I don't think there's hardly ever free money, but I feel pretty good about saying these comparisons are apples to apples in terms of what you're getting, and there's more money somewhere else.

Tom: Worth looking into.

Brendan: Yeah, it's worth exploring.

Tom: All right, we want to move on to another topic that is close to a third rail topic, but we're not going to go there, but we kind of need to bring up somebody's name just to introduce the topic. So, Bernie Sanders is running for president. One of his campaign pitches is free college education, or basically canceling the debt of ... canceling student loan debt. The way that he proposed paying for it is through a financial transactions tax, and this is where we want to take a look at, because as you so aptly put it before we turned on the microphones, there are ripple effects that can come from something like this.

Brendan: Yeah, I think, first let's just talk about what this tax actually is, because it's not something that Bernie Sanders has dreamt up in his mind.

Tom: No.

Brendan: It occurs all over the world. I saw a stat online that 40 countries, as of today, around the world have some form of a financial transactions tax.

Tom: That's correct.

Brendan: The U.S. currently has one, by my estimation on roundtrip trades, it sounds like they tax about half a penny, maybe, a little bit less.

Tom: That's about right.

Brendan: 42% of one penny, that's the number that I came up with, and this is ... it's referred to today as a Section 31 fee. So, I thought it would be interesting to bring that up, and then to talk a little bit about how that tax is currently passed through the system, and who ends up paying it along the way. So, this is a tax that currently it funds the Securities and Exchange Commission, the SEC, and so right now the tax comes down from the SEC to self regulatory organizations like FINRA-

Tom: FINRA, right.

Brendan: ... and exchanges. So, like the New York Stock Exchange-

Tom: Right, Chicago Board Options Exchange, New York Stock Exchange-

Brendan: Nasdaq, BATS-

Tom: Sure, yep. All of these ... yes.

Brendan: ... all of these places who then pass it on to broker dealers, places, and custodians. So places like your TD Ameritrade's, your Merrill Lynch's of the world, Morgan Stanley's, places where you can custody assets and place trades, and then goes on to the end investor. So, just interesting to see how a tax like this starts somewhere and ends in a totally different place, and everybody along the way is chipping in a little bit, but ultimately it generates enough money to fund the SEC, at least part of it comes from that, which is not nothing.

So, obviously, 42% of one penny, nominal and something that most people don't even notice right now, that's not what we're talking about, at least as the proposal stands today, I think Bernie Sanders is talking about having a half of 1% tax on stock trades, 0.1% on bond trades, and about half of that on derivative trades. Supposedly be a tax credit that would refund these costs to anybody making less than $50,000 a year if they're single, or $75,000 year if they're-

Tom: Married people, right.

Brendan: ... married filing jointly. It just brings us to the ripple effects though. So, how would a tax like this impact the system and investor behavior, all of that, it's a lot to consider, right?

Tom: Well, we actually have a real life example. In 2011 when the EU was struggling with the euro, one of the things that they proposed was this kind of transaction tax, and in their proposals and their plans, they forecasted that they would receive somewhere in the neighborhood of €30 billion to €35 billion a year.

Brendan: This is where it's tough to project that, because to do a projection like that, I would presume, I don't know, but I would presume that they're taking the proposed tax rates, and applying it to today, or an average of the last several years, trading activity, trading volume, moving forward. I know that ... I mean you have to make a projection off of something, so I get that that's where the numbers come from, but would a tax like this mean less trading in the future, and if there's less trading in the future because it's being taxed, then does the tax generate the revenue that you thought it was going to when you implemented it?

Tom: Well, let's look at the numbers. France alone, they said their number is something like €3.5 billion a year where the forecast was €30 billion to €35 billion, I mean, a 10th of what they were expecting. You start to think about these ripple effects. What if people slow down their transactions? What if people start flooding money into more passive investments, index based type of things?

Brendan: Also, what if I ... because I would guess if one country sets a rate, unless this were a uniform thing like across the globe where we're going to do this in every country across the globe that has a stock exchange, if you implement something like this in the U.S. and there's a lower tax or no tax on exchanges in some other country, then I would guess that people are probably going to find ways around this, and people finding ways around legislation is something that you can't ... We can guess at how people might do that in the future. We don't know for sure, but I do know for sure that people would do it, because when there's real dollars on the line, and people can save costs and have more profit for themselves, they're going to be as intelligent as as they can be. They're going to ... The ingenuity is really going to come out, and people are going to invent ways to circumvent stuff like this.

Tom: We're going to see trading desks open in London and Tokyo, and we're going to see all the trades done overseas in a way to circumvent something like this.

Brendan: I think it ... and it ... The proposal, I think, is popular with with most individuals, because there's a general disdain for who this ... It's positioned as if the banks, and the hedge funds, and these speculators, and Wall Street at large are going to pay stuff like this, but I mean, is it going to be passed through the ranks? Because I would guess that if there are additional costs on things like big banks and trading desks, I don't think they're just going to sit there and eat that and become less profitable. I mean, they may eat it to some degree, but I think they're also going to pass it along to everybody who uses their stuff. A lot of people use stuff that comes down from big banks, because a lot of them run things like mutual funds, or advisory services, and trading platforms.

Tom: There was actually a much ... I shouldn't say a much larger fee, but the transaction tax was lowered, I believe it was cut in half, in part of the budget deal in 2000. So, it's less than it was even 20 years ago. So, it's something that they've had.

Brendan: Well, I mean, it was floated, I think I saw a paper from the '80s, I want to say it was Larry Summers, I don't know, you can correct me if that sounds wrong, but it's been floated before in the past as a way to curb speculation in trading because that's no good, and more recently I think it's been floated probably as a solution to a high frequency trading. But I'm not sure that that's necessarily a problem that needs solving, because a lot of the high frequency trading provides liquidity to the system and gives people the ability to trade at tighter spreads on their money. So, is less trading, is that a net positive for liquidity? And if it makes securities less liquid then, I mean, you're also, you're then being taxed more on new transactions, but you're also maybe paying a higher cost because bid-ask spreads have been blown out, and that's-

Tom: Correct.

Brendan: ... because there's a lack of trading going on. So that, I mean, I think something the article said is that something like this ends up flying in the face of like a decades long transition now from higher costs to lower costs for everybody, but especially the individual investor out there, and-

Tom: Sure. all those ... I mean, we spent 20 years trying to narrow the spreads, we went from quarter point increments to eighths, to pennies.

Brendan: Yeah. You literally ... At the beginning of your career you wouldn't even get quoted, and today we get, "Such-and-such is trading at $80.05.", you would get-

Tom: It would be-

Brendan: ... a flat number, and then-

Tom: ... 80 to a half. Yeah, 80 to a half.

Brendan: ... it's a mystery where the rest of the money goes.

Tom: I know where it went.

Brendan: Well yeah, we all know where it went, but-

Tom: Yeah, it's creating a lot more questions. So, what happens with mutual funds? What happens with ETFs? I mean, these are baskets of stocks. When they need to go in and ... When you buy something like IJR, that's the small cap 600, there's 600 stocks in that basket. Is that 600 transactions to buy? That the fund creator has to buy? How are they doing this? It hasn't really been fleshed out.

Brendan: No, I think that's ... I mean, and that's a staple of politics overall, is that the details of how things in the future will be paid for are never fleshed out, and that is not unique to Democrats or Republicans. That is literally across the board. The politicians don't actually care about the logistics of how their campaign promises will be fulfilled one day. It's just a matter of getting people to believe that they will be fulfilled regardless of nuts and bolts.

Tom: Vote for me and I'll get back on the details.

Brendan: I'll figure it out later. Right, yeah.

Tom: Just trust me, I'm a doctor.

Brendan: Right.

Tom: So yeah, we've got a long way to go on that. They're certainly getting a lot of attention.

Brendan: Yeah.

Tom: This is another part of it. What'd you call it, second level thinking, third level thinking?

Brendan: Yeah, it's like Rumsfeld back in the day would say, "There are the known unknowns and the unknown unknowns." You've got your second and third level consequences here. I mean, it just ... There's a lot to consider, and we can only consider so much, because there are things that would occur as a result of something like this that literally cannot be imagined today. There is no way that we can think up all the possibilities, because until they occur people don't have the incentives to think on that kind of a level.

Tom: Yeah. What are you doing for Independence Day?

Brendan: The beach, hopefully.

Tom: Good.

Brendan: Yeah. What about you?

Tom: I think I'm going to declare my independence from the New York Mets.

Brendan: Yeah, I might be there with you, it's been ... June was a rough one again. June of 2018 was pretty dismal, and I don't think June of 2019 was all that much better.

Tom: Go look at June of 2017, also bad.

Brendan: June swoon for the Mets. We should sell in May and go away.

Tom: Good point. Well, with that, we'll wrap up episode 264. Thanks for tuning in. We'll catch you on the next one.