Capital Gains are GOOD - Transcript

Tom Mullooly: Welcome to the Mullooly Asset Management Podcast. This is episode number 266. Thanks for tuning in. I'm one of your co-hosts, Tom Mullooly, and with me today, Timothy James Mullooly.

Tim Mullooly: Hello everybody. We have two very good articles that we want to talk about today. Both kind of have, from us, the same message. Tom, which one do you want to start with?

Tom Mullooly: Let's talk about the Vanguard Blog because it talks about capital gains.

Tim Mullooly: Right.

Tom Mullooly: Near and dear to my heart.

Tim Mullooly: Yeah, so this was, like Tom just said it was on Vanguard. We'll link to it in the show notes. The title of the article was "Capital Gains are a Good Thing". From an investor standpoint, we get calls a lot that say the opposite. People are like, "Oh I have too many capital gains," or, "I have too much in capital gains. I can't do anything with these investments because I have too much in capital gains."

But the author of this article is here to kind of put that to bed and say capital gains are a good thing. And I liked the way that he started the article. Good analogy, and it kind of puts things into perspective. He said, "Imagine someone winning an Olympic gold medal, walking up to the podium, and then turning and running away from it. And when a reporter asks them afterwards, 'Why'd you do that?' They'll say, 'Taxes. If I bring home my gold medal, I'll be taxed on it.'"

Tom Mullooly: All right.

Tim Mullooly: That's ridiculous.

Tom Mullooly: So I'm actually going to hit the pause button there because this is something that I learned. Up until 2016, Olympic medalists were taxed on the medals that they received. I had no idea-

Tim Mullooly: I mean, they're gold.

Tom Mullooly: ... that that actually happened.

Tim Mullooly: Yeah.

Tom Mullooly: How about like, okay, you work your ass off. This has become your non-paying career. Because you can't be a professional, unless you're in the NBA. You work your whole life for this, and all you get is this medal. Of course, all the fame and recognition that comes along with it.

Tim Mullooly: The endorsements and sponsorships.

Tom Mullooly: Yeah, the Wheaties box.

Tim Mullooly: Yeah.

Tom Mullooly: I get it. But for goodness sakes, they're going to tax that, the medal?

Tim Mullooly: Yeah. That's something that I also learned in the article as well, but-

Tom Mullooly: That's pretty chintzy.

Tim Mullooly: Yeah.

Tom Mullooly: I'm sorry. I've got a problem with that.

Tim Mullooly: Yeah, I agree with that. But the point underneath it being that just because of the gold medal is going to be taxed when you bring it back-

Tom Mullooly: You're not going to pass it up.

Tim Mullooly: Yeah. If you're an Olympic athlete, you're not going to ... it's not going to stop you from competing and winning the gold medal just because you're going to get taxed on it. And he said it's the same thing for investors and them avoiding realizing capital gains just to avoid the tax on it.

Tom Mullooly: Yeah, that's a mistake. You can't go broke taking a profit. Paying taxes is the least of your problems.

Tim Mullooly: Right, exactly. So if you think of investing as an Olympic competition, or any kind of competition, the objective of the game is to make money.

Tom Mullooly: Right.

Tim Mullooly: So if you have capital gains, you won.

Tom Mullooly: Right.

Tim Mullooly: You played the game, and you won. Not saying that investing is a game. It's not, it's serious business. But-

Tom Mullooly: I keep thinking of Herman Edwards when you say that.

Tim Mullooly: You invest to win the money. But it's a kind of like, "Woe is me," I guess. Like, "Oh, I have to pay money. Oh, my investments went up too much. I have to pay capital gains tax." It's like your investments could have went down, and you could have lost all of your money too. So-

Tom Mullooly: What do you want?

Tim Mullooly: Which one do you want?

Tom Mullooly: Yeah.

Tim Mullooly: Do you want your investments to go up and you make money, the point of investing, or do you want your investments to go down and you lose your money? I don't know.

Tom Mullooly: The author actually brought up an interesting point that I think is worth discussing. He talked about in 2006, if you had a 60/40 portfolio and you did not rebalance, and rebalancing is where a lot of investors wind up generating capital gains because you're selling something that's become a little overinflated, a little out of balance, and you want to get back in balance. And so he talked about if you were a 60/40 allocation, so you had 60% in stocks, 40% in bonds in 2005. 2006, the market worked out great. 2007, the market actually worked out great. But then if you didn't do any rebalancing, now you're 60/40 portfolio two years later, heading into 2008, is now actually 70/30.

Tim Mullooly: Or more.

Tom Mullooly: Right. The problem is if you continued to not rebalance, you go through 2008, and in March of '09, at the bottom of the market, you actually had less than 50% of your money in stocks. So you actually had less there ... it was harder for you to get back on track.

Tim Mullooly: Right. Yeah, the more aggressive portfolio, the 70/30 or the 80/20 would have gotten hit harder than a 60/40 portfolio would in something like 2008, and the same goes for any future market downturns. So avoiding these capital gains, realizing the capital gains to avoid these taxes, makes your portfolio significantly riskier if you're not going to rebalance and kind of sell these stocks as they go up every once a year, every other year, however often you rebalance.

Tom Mullooly: I don't want to get too far down a rabbit hole, but I have to confess that when the idea of rebalancing really started taking off in 1998, 1999, about 20 years ago, I used to sit there and say, "Why in the world would anybody rebalance?" You're selling what's going up and you're buying more of what's been going down. That doesn't make sense to me.

When you talk about rebalancing, it actually is worth looking at. It's important to have rules when you go into these things. Does it mean you have to sell everything, like the entire position of an investment that's been going up? No. Take some money off the table and use that to rebalance back into things so you keep your account balanced. That's really important.

Brendan’s run the numbers, and he can show you over periods of time how 60/40 portfolios and 70/30 portfolios, meaning 70% of the money is in equities, 30% in bonds, that these kind of balanced portfolios will give you nearly all of the market type returns without having 100% of the money in the market.

Tim Mullooly: Right. Yeah, so it's definitely something to not avoid just because you don't want to pay the tax on your stocks that have appreciated over time. Something that we hear a lot from clients, and he also mentioned it in the article, was people tend to overestimate their tax bill too.

Tom Mullooly: Oh-

Tim Mullooly: I mean-

Tom Mullooly: ... all the time.

Tim Mullooly: ... over the span of your career, how many times has someone called in and say, "I'm getting slammed on taxes," or, "I'm about to get whacked on taxes." It's like, "Are you? Are you really?"

Tom Mullooly: Are you really?

Tim Mullooly: What is the long-term capital gains tax rate for most people?

Tom Mullooly: For most people it's 20-

Tim Mullooly: 15 or 20%.

Tom Mullooly: 15 or 20%. Okay, let's put this in dollar terms so people ... because they're like, "Oh my god! 20%!" They're in the 25 or 28% tax bracket.

Tim Mullooly: But it's of the gains too.

Tom Mullooly: Right. That's what they miss.

Tim Mullooly: Yeah. It's not your whole investment. If you initially invest $100,000 in a stock and it goes to $102,000, you're paying capital gains on the gains, the $2,000. So it's 20% of $2,000, not 20% of $102,000.

Tom Mullooly: Yeah.

Tim Mullooly: So all in all in dollar terms, it's usually a lot less than people actually think once they see the numbers. They're like, "Ah, that's not that bad." Like, "Yeah, let's do it."

Tom Mullooly: The other thing that we should also point out, not mentioned in the article, but if you're investing through a retirement account, you don't pay tax on the gains until the money comes out of the account and then it comes out of the account as ordinary income. If you have money in an IRA and you're sitting on gains, you can sell the positions that are in there, rebalance, no taxes.

Tim Mullooly: Yeah.

Tom Mullooly: That's important to remember.

Tim Mullooly: Yeah, not rebalancing a retirement account for the same reasons we were just talking about, is even less intelligent than in a taxable account or some other type of account that isn't tax deferred.

Tom Mullooly: So the author also quoted Michael Kitces, who writes a very popular blog in our industry called "The Nerd's Eye View," and he points out that there's little economic value in avoiding a capital gain. Like saying, "Hey, I don't want to sell that investment because we have such a big gain."

Tim Mullooly: Right.

Tom Mullooly: For an investment, he pointed out with a ... If you've got an investment that's got a 20 to 30% gain, the annual value of avoiding that capital gain is about the same as a single day's worth of volatility in a stock. So let's put this in numbers. Suppose you put $100,000 into an ETF and it grows to $120,000. All right? So you've got a taxable gain of $20,000. The 20% tax on a long-term capital gain is about $4,000.

Tim Mullooly: Yep.

Tom Mullooly: That is equivalent to $120,000 investment. That's like a 3%, 4% move in an ETF.

Tim Mullooly: Yeah.

Tom Mullooly: Happens every day. I don't really understand what they're talking about.

Tim Mullooly: Right, and that goes back to the overestimating how much all of this really matters.

Tom Mullooly: Yeah.

Tom Mullooly: When we talk about these kinds of things, there's another article that I think is worth zooming in on. This was actually in the Wall Street Journal.

Tim Mullooly: Yeah.

Tom Mullooly: Around the same time.

Tim Mullooly: I think both of these articles, for me, kind of fall under the I lack sympathy for you problem. They're both nice issues, I guess, to have for people.

Tom Mullooly: First World problems.

Tim Mullooly: Yeah, pretty much. So this next article from the Wall Street Journal, the headline says "Congress is Coming for your IRA," which is already kind of misleading.

Tom Mullooly: Inflammatory.

Tim Mullooly: Yeah, and then the subheading says: "The SECURE Act would upend 20 years of retirement planning and stick it to the middle-class." My Gosh. Talk about fear-mongering, clickbait to get people all riled up.

Tom Mullooly: And let's be clear, this is an opinion piece that was published in the Wall Street Journal and the author is ... he wrote a book. I'll just give you the title: The Overtaxed Investor: Slash your tax bill and be a tax alpha dog.

Tim Mullooly: Tax alpha dog.

Tom Mullooly: What in the world is that?

Tim Mullooly: I have no idea, but when you read that at the end of the article, the rest of the article makes sense. Because like you said, it's an opinion piece and this guy is just talking his book.

Tom Mullooly: So let's talk about the SECURE Act. SECURE stands for Setting Every Community Up for Retirement Enhancement.

Tim Mullooly: I must have glazed over that in the article, because I didn't know that's what it stands for.

Tom Mullooly: Yeah.

Tim Mullooly: That's kind of funny.

Tom Mullooly: Here's the worst part is that it was passed through the House with a vote of 417 to three.

Tim Mullooly: The main parts of the SECURE Act, I think the one that he touches on the most and that people have been harping on, is the fact that it's essentially eliminating the stretch IRA, which is... The stretch IRA, the way it works now, is if you inherit an IRA from someone as-

Tom Mullooly: Not your spouse.

Tim Mullooly: Right.

Tom Mullooly: Right.

Tim Mullooly: You can stretch, hence the stretch IRA, you can stretch the payments over your entire life expectancy so you take out less money each year. It lessens the burden that you have to take out each year.

Tom Mullooly: So prior to 1999, what would happen is if somebody passes away and they left an IRA to a beneficiary, a beneficiary who's not their spouse-

Tim Mullooly: Right.

Tom Mullooly: Because the rules before and after 1999 for spouses remain the same. Your spouse passes away, everything gets rolled over into your own IRA, not a taxable situation whatsoever. All right? However, if the beneficiary of an IRA is not the spouse, now we have a situation, prior to 1999, it was okay, you inherited this IRA. You can't roll it over, and too bad. Here's the gross amount. Here's what you have to pay in taxes. Here's a check. Have a nice day.

So in 1999, they permitted these stretch IRAs, they're also called beneficiary IRAs, where the IRA now gets rolled over, tax-free, to a beneficiary, whoever the beneficiary is in the account. And this is going to, if this thing gets signed by the president, this is going to be true for everybody who dies after 2019. What they're talking about is basically the rules are going to change. Let's walk through them briefly so people understand.

Tim Mullooly: I think the main point is that it's accelerating the time that you have to take the money out of the account. It's not going back to the way it was before 1999. Like you said, they cut you a check. Here you go.

Tom Mullooly: Right.

Tim Mullooly: If you don't want it, oh well, you're getting it.

Tom Mullooly: So now, the current scenario for someone who passes away prior to this SECURE Act becoming law, is suppose you pass away with a $1 million retirement account and your beneficiary is 25 years old. That person needs to take a required minimum distribution, even though they're not 70, they're 25.

Tim Mullooly: Right.

Tom Mullooly: They have to take out a piece every year for the rest of their years going forward, based on their life expectancy. And that number doesn't change.

Tim Mullooly: Yeah.

Tom Mullooly: And so that person, under that scenario that I just gave you, that person would be looking at a distribution each year of a little over $15,000 a year. But they've got 1 million bucks sitting in a retirement account that they're going to stretch out. Someone who's 25.

Tim Mullooly: Yeah.

Tom Mullooly: They're going to live for 50 or 60 years.

Tim Mullooly: Yeah. Again, that's why it falls under the nice problem to have, I think, in my book, First World problems. You have $1 million. You just inherited $1 million.

Tom Mullooly: So let's talk about what the outcome is going to be now.

Tim Mullooly: So instead of being able to stretch it over your life expectancy, a non-spouse beneficiary who's getting this money has 10 years to take that money out of the IRA in distributions to themselves. So in that same example where you use $1 million, that person has 10 years to take $1 million out. So-

Tom Mullooly: They can take out-

Tim Mullooly: ... the minimum would be roughly $100,000 every year.

Tom Mullooly: On the flip side, if they were to take the average, it would be about a hundred grand a year that they'd have to realize. Also can operate under the plan where they don't take anything out for the first nine years and then in year 10 ...

Tim Mullooly: Empty it.

Tom Mullooly: Empty it out.

Tim Mullooly: Yup.

Tom Mullooly: Gains and all. Let's say you've put $1 million into your stretch IRA, or beneficiary IRA, and under the new rules, now this $1 million, over 10 years, grows to $2.4 million. You don't take anything out. You're going to have pretty big check to pay.

Tim Mullooly: You're paying your gains at that point on the $1 million.

Tom Mullooly: Well actually, yeah, the $1.4 million gain, plus you're taking out the $1 million as well.

Tim Mullooly: Right, yeah.

Tom Mullooly: It's a huge thing. It's 10 years. It's not like you have to take it out, the old way, all at once.

Tim Mullooly: Right, and it's still ... The whole thing with inheritances for people, I mean, we call it a burden, but is it really?

Tom Mullooly: This is an inherited IRA.

Tim Mullooly: It's found money. You didn't work for it, you did nothing for it. Someone died and gave you this money for free essentially. People just get so caught up on that gross number and then when they get the net check after taxes and everything, then it's like, "Oh, well, I was supposed to get $100,000 but I only ended up getting $70,000." Oh my gosh.

Tom Mullooly: Yeah.

Tim Mullooly: God forbid you only get $70,000. Poor you.

Tom Mullooly: It's found money.

Tim Mullooly: Come on.

Tom Mullooly: The author also goes into the point where the IRA owner could still leave the account to a surviving spouse, who would remain exempt from that 10-year clock, but the widow would be paying taxes in a higher filing single tax bracket. The bracket can easily easily jump from 12 to 25% or 24 to 35% as the mandatory payout ratios automatically increase with age. This is where the author has a little fun with numbers. "For example," he writes, "the required minimum distribution for a 70-year-old is 3.7% of the retirement account balance." We tell everybody use 4% for the first year or two. It's a good back of the envelope number.

Tim Mullooly: Right.

Tom Mullooly: So for a 90-year-old, the required minimum distribution rate is 8.8%. Sounds like a lot, but remember, you've been taking money on a mandatory basis for 20 years at that point.

Tim Mullooly: Yeah.

Tom Mullooly: So the account's going to be smaller. 8.8% is not that big a deal.

Tim Mullooly: Right.

Tom Mullooly: And if you don't have income over, I think it's $10,000, you're not going to be filing a tax return anyway.

Tim Mullooly: No. Let's real quick just touch on one last thing that this author was lamenting about in terms of the financial aid and need and how this is going to-

Tom Mullooly: Unbelievable.

Tim Mullooly: ... impact families. Do you want to break down his argument?

Tom Mullooly: So he says the SECURE Act would be a college planning nightmare for middle income parents. If the parents of college age children inherit $500,000 in an IRA. I'll say that again real slow. If middle income parents inherit a half a million dollars, the resulting highly-taxed distribution, say 50 grand a year for 10 years, would make them richer on paper than they actually are, eviscerating ... that's a Scrabble word ... eviscerating their ability to qualify for need-based financial aid. Let's say that again real slow.

Tim Mullooly: Wait. Yeah, for what?

Tom Mullooly: Need-based financial aid. You don't have a need. You just inherited a half a million bucks.

Tim Mullooly: Right. Richer on paper. What does that even mean?

Tom Mullooly: Yeah.

Tim Mullooly: Richer on paper. They have the money. The money is there. They got $500,000. You don't need money for college if you just inherited $500,000. That's your financial aid.

Tom Mullooly: That's right.

Tim Mullooly: That inherited IRA becomes your financial aid. You don't need money for school. You have it.

Tom Mullooly: Yeah. We should just link to it in the show notes because everyone's got to read this thing, because it's terrific.

Tim Mullooly: Yeah.

Tom Mullooly: Yeah.

Tim Mullooly: Again, kind of, "Woe is me. Oh, I make too much money. My investments went up too much. I inherited too much money." You could have some seriously worse problems, trust me.

Tom Mullooly: But before you make a financial decision involving these kind of things, talk to a financial planner. We'd be happy to speak to you as well. But thanks for listening to episode number 266 of the Mullooly Asset Management Podcast. Catch you on the next episode.