The Building Blocks of Investing - Transcript

Tom: Welcome back to the podcast. This is episode number 288. Thanks for tuning in. This is Tom and Brendan here. Ready to discuss the world.

Brendan: Good thing to lead off with is a reminder. Calendar year, people like to do things that they do like once a year, and something that I think everybody should do once a year is check out their tax withholdings.

Tom: Should they do this after they change the batteries in their smoke detector?

Brendan: Hey, whatever gets people to do it is great. If you want to do it arbitrarily at the beginning of the calendar year, terrific. I think the more important thing is that you're just doing it.

Tom: Yeah. You have to be aware of these things. I think a lot of people were caught flatfooted a year ago when they were all... Not all, but many people were expecting some kind of big tax refund and didn't really materialize.

Brendan: Right. So in 2017 at the end of the year, we saw the tax code changed. In 2018, people's W-4, which is the form that you elect to have income tax withholding on, for most people, unless you're self-employed or are working on 1099 basis, but the W-4 didn't really translate any more with the changes in the tax code to exemptions. You claim exemptions on there and exemptions don't exist anymore. And so people were a little confused about what they were withholding and whether it was enough.

Tom: They also changed the amount that if you declared certain exemptions, the numbers, the math actually changed. And so people found out that they got their, I'm sorry if I'm stealing your thunder, but they actually got their tax refund in every pay period. They got a couple of bucks more in each paycheck because the withholding actually changed.

Brendan: Yes. So whether that, or in conjunction with what I was describing before that, that was the point that I was headed towards, meaning people were surprised at the tax return or lack thereof, refund rather, that they got from their 2018 taxes. And so even if what I'm about to share had not occurred, it would still be a great time to just take a look at what happened over the course of 2019 and if you're not on a trajectory that looks good for 2020 you can change it. And to change it in the beginning of the year probably means the least amount of pain possible in terms of adjusting your withholdings. But in addition to that, the W-4 has been reworked now for 2020 and if you go use the new tool, it's a worksheet and it takes you through some steps to hopefully come at what will be very close to your actual tax bill.

Just on a first pass. It looks a lot more thoughtful than prior versions of it because it kind of speaks to the dual income household, which is very common these days, or people who have multiple jobs and this was something that was not... You weren't really getting this guidance on the prior notion of the W-4.

Tom: Never.

Brendan: And so it seems helpful on the surface. I haven't played around with the tool, but I think it's great and calendar year turning over, why not make use of the new tool and make sure that, as you start the year, you're hopefully on track for your tax withholdings.

Tom: Brendan brings up a good point, doing it at the beginning of the year. If you're listening to this in December of 2019 looking ahead to 2020, you're going to have all of your paychecks in front of you. One of the worst conversations we can have with a client is that they discover that they've been under withheld in November. There's not a lot you can do. You only have a couple of paychecks left at the end of the year. It's going to be really hard for you to catch up.

Brendan: Yeah. You could make an estimated payment ahead of time or just start preparing for the idea of needing to send a big check in with a tax return, come the prior or the following April rather. Yeah. The more time you give yourself to adjust to things like that, the better because even if you're off by a couple thousand dollars in your withholdings, when you end up doing the math, a couple thousand dollars over 26 pay periods, or 24, or even 12 is a lot less painful than having to make a lump sum payment to catch up at the end of the year.

Tom: There've been times in the past where I'm writing a check out to Uncle Sammy and I'm saying, "That's my vacation money going to get me caught up on taxes." That's a drag.

Brendan: Right. You'd rather pay as you go because it feels less painful even though you're paying the same bill regardless of how it occurs.

Tom: Sure.

Tom: We're recording a podcast and so we have to mention the word Christine Benz.

Brendan: We actually haven't discussed anything of hers in a couple of months now.

Tom: You're right. Well, we've had Jeff Ptak. We find that content at Morningstar to be fantastic, especially for our listeners. So that's why we share it a lot. And thanks to Christine and Jeff and everyone else at Morningstar for producing some really noteworthy content. So do you want to talk about Christine's investment pyramid?

Brendan: Christine put together a pyramid in terms of how you should think about priorities when you're trying to invest your money. And this was modeled off of the old food pyramid, if you wondering where this concept came from. Hopefully it ages better than the food pyramid. Christine kind of made a joke about this at the onset of the article.

Tom: Yeah. In the 70s everyone thought of the food pyramid was well, chocolate at the bottom and ice cream in the middle and it didn't really work out that way.

Brendan: Yeah. Some of the recommendations in terms of what the base of the pyramid should be turned out to not be so great, but that's only as we're looking at it today. It seems like these dietary things change all the time, so we could be looking back in 20 more years saying "Oh, never mind they were actually right in the 80s. We don't know."

Tom: So what's at the base of Christine's pyramid?

Brendan: Just generally like having a goal which is huge, even though it sounds ridiculous. Plenty of people come across our conference room table here where we're recording and they've never really thought about why. Why are you investing your money? Because that makes a huge difference.

Tom: Sure it does.

Brendan: The range of things that you could be investing for, it's immense. And that alone will just change right off the bat what you're doing and how you're doing it and why.

Tom: And I'm just going to expand briefly on what you just said because, it's true when we bring that question up during our meetings with some folks, we ask them what's the goal or what's the reason behind all this savings? And you can tell the folks that have goals and the ones that don't, because the ones that don't have goals tend to shrug your shoulders and say-

Brendan: "I don't know. I thought I was supposed to."

Tom: Yeah, "I thought I was supposed to do this." But they have no rhyme or reason why and they'll likely going to have no rhyme or reason why they dismantle the savings when they need it.

Brendan: If you don't have a purpose for what you're doing, then how do you know if it's working or not?

Tom: Right.

Brendan: You just decide based on arbitrarily what's occurred over the last couple of months. This isn't working anymore. I don't know. How do you know if you don't know what you're aiming for?

Tom: Right, exactly.

Brendan: So the next leg up the pyramid in terms of, again, this is for your investments, is how much you're saving. Obviously the base here, this is the boring stuff. Quote unquote. But this is the stuff that actually moves the needle as we get closer to the top. I think some people might be surprised to learn what doesn't move the needle that much.

If you earn the best investment returns on the planet, it's not going to matter if you're not saving a healthy percentage of your paycheck. You can outperform the market every year, and if you're saving two and a half percent of your annual pay, you're never going to have enough to retire on. It doesn't better.

Tom: It means nothing. And your luck is going to run out at some point too.

Brendan: It probably will, but let's assume you have perfect luck. It's still not going to matter.

Tom: So the whole idea behind how much you save is really... We try to keep the matheyness out of this. It's breaking down a problem into bite sized chunks. If you've got a goal, something that you're saving for, you can break that down into how many paychecks you get, just like you would with your W-4, and how much tax you want taken out of each paycheck. How much do you want to save each period to get you to your goal? Very important. But a lot of people don't do this.

Brendan: Yeah. And so after you've determined why in the world you're doing this and how much you need to save to do that thing, you should start to consider your asset allocation. And by asset allocation we just mean the high level mixture of stocks and bonds, because a 100% bond portfolio is going to have very little volatility and also very little growth prospect. And a 100% stock portfolio is going to have high growth prospects, but it's going to be all over the place in terms of the volatility and what it's worth on a day to day basis.

Tom: Let's just stick with this step on the ladder for one split second more. I'm guessing a lot of advisors get phone calls and emails like we do where people say, "All right, what's the game plan to protect our profits? The market's been pretty good this year, what do we need to do to sidestep a big crash or a big drop in the market." And we tell people all the time that, for a lot of these folks that are asking, we're managing retirement money or money that should be not be spent for 25 years, 30 years, 35 years. The money that you're going to need in the next two or three or four years should not really be exposed to the market. Am I right?

Brendan: You're right.

Tom: You know, we tell folks all the time, we need to know, like all advisors need to know, they need to have that level of communication with their clients that, "Hey, I'm looking to do something in the next two or three years." You're going to have a completely different asset allocation if your goal is getting really close up in the window.

Brendan: Right. So that completely speaks to the two rungs lower on the ladder.

Tom: Right.

Brendan: How much are you saving? That's going to be dictated by how far away this goal is. When is this goal? And that's the bottom, having a goal. So these all speak to one another. And I think the order in which you take them is intuitive because you can't do the higher up levels of this pyramid without first having covered the bottom ones. So chronological, makes a lot of sense. So once you figure out your asset allocation, the next thing up the pyramid here is to control your own behavior. Meaning that if you have a goal, you know how much you're saving to get there and when it's going to be, you have an asset allocation that speaks to both of those thing, you got to just stick with it and that is so much easier to talk about on a podcast than it is to actually do and especially in a year like this where you know if we're just talking calendar year 2019, we have not really had a ton of stuff for people to react to and I don't think we've even had a full on 10% draw down in this calendar year.

Obviously, we're coming off a year where we had a 20% draw down at the end of it.

Tom: Everyone forgot about that.

Brendan: Right. And the people who forget about that are the ones who want to change the game plan now to get more aggressive again when they don't need to. Like you determine an asset allocation and it is the way it is because of when your goal is and what you're going to need and how much you're saving. This confluence of these factors here are going to make that asset allocation, what it is.

So unless those lower down steps on the pyramid here have changed, meaning the goal is coming sooner or the goal is going to be later or you're saving more or some of these other factors, those could change your asset allocation, but your behavior and your feelings on a day to day basis about the market-

Tom: That's all you, man.

Brendan: Really should not be impacting the asset allocation. But it better not.

Tom: But it does.

Brendan: But it does a lot for people. Unforced errors as Charlie Ellis likes to talk about, in terms of freaking out when you don't need to.

Tom: Right. Okay. Moving up the ladder.

Brendan: Being tax efficient. And we talk to clients all the time, and this especially pertains to brokerage accounts outside of stuff like IRAs or workplace retirement plans.

The idea of why we use ETFs instead of things like mutual funds or individual stocks because of their tax efficiency, because you, as the end user, recipient of the funds from an investment portfolio, eventually you get the after tax, after fee returns on your money. And so if you made a bunch of money but you had to do a ton of trades and they were all short term capital gains, you need to calculate that into your return and really, nobody who does trading, ever does that.

They're just like, "Oh yeah, I'm the best. I make great returns." And they don't actually calculate any of this stuff and you are going to spend the money that's left over after fees and taxes and all these other frictions and so being as tax efficient as possible, it's the smartest thing you can do to keep as much of your money as possible. Just be should be aware of the bite that taxes are going to take out of your returns if you're not doing things intelligently.

Tom: We've gone five steps up the ladder. When do we get to the point where we decide Exxon versus Chevron?

Brendan: This is the point on the pyramid, investment selection.

Tom: So this is the point, this is the very tippy top of the-

Brendan: The very, very last thing that you should be thinking about discussing, spending your time on, investment selection. And just in my experience talking to individuals and families about their investments, pretty much everybody in America turns this thing completely upside down and wants to talk specifically about investment selection without addressing any of these other things and that's exactly backwards.

Tom: It is. And and Brendan's right, and I can go back in my own career and tell you time after time. That's where the mistakes happen, is they get this inverted pyramid and they start with, "Should we buy AOL or compact computer?" Both gone by the way. What should we put our whole account into?

Brendan: Without the context that the rest of this pyramid provides, that's pretty much useless. I will add that I can't fully fault people who think this way because the entire financial media industry acts as if this is what is the most important thing in the world. They sit on TV all day talking about this fund or that fund, this stock or that stock. It's entertainment for a reason because it's pretty much meaningless to the bottom line of most people's finances or there are at least a dozen other things they should be thinking about beforehand.

Tom: Now I think we cited, something else that we can tie into this, in the last episode, in episode 287, we talked about that investor survey where it showed that, or maybe it was one of the last videos that I did, but investor survey that showed that most people who have less than $50,000 have a stock portfolio, which is stunning. It's really stunning. Because basically... Yeah, it was a video. It basically says, "Hey, I've got $40,000 and I'm going to put it on three stocks."

Brendan: Right. I'm going to bet it all on black today and hope that I get rich from it.

Tom: Pretty much.

Brendan: Yeah. It's a get rich quick mindset and I have to tell you it's a bad one.

Tom: It's troubling.

Brendan: Not a good one.

Tom: It's very troubling, because that's when people come into us and they say, "What's better?" I just use those two examples of companies that are no longer around.

Brendan: I think that a lot of times when we walk through, we're usually walking through the financial planning process addresses a lot of these steps on the pyramid that lead us to the investment selection, which we're happy to discuss with people after we've fulfilled the requisite work to get to that tip of the pyramid here.

We do do that and when some people hear that that's how we ultimately back into how we are going to make this specific selections for their portfolio, I think it's intuitive and a lot of people are like, "Yeah, that makes a lot of sense." But there are some people out there that just don't want to hear it. We can't help everybody. If they want to talk stock picks within 10 minutes of meeting our firm, we may not be a good match.

Tom: We're not going to be a good match, I can tell you right there.

Brendan: Yeah.

Tom: It's something I think that won't go away because the whole idea with stocks is that it gives the financial media something to talk about. There's nothing to talk about really when it comes to an asset allocation or even an exchange traded fund. It's a basket of stocks that tracks an index. That's about all you can say about an exchange traded fund, but company X, Y, Z, which I'm making up, they come out with earnings every 90 days. There's something to talk about.

Brendan: They sell things that you hold in your hand or you go to their store and tangible thing. It makes it fun, but I hate to break it to everybody out there, that this is like serious business. This isn't supposed to be fun. That's not what this is for.

Tom: But this gives the media something to talk about all the time.

Brendan: Doesn't mean that anybody needs to pay any attention to it or have it impact their real world actions. If you want to watch it and be entertained, that's one thing, but don't believe those people are trying to help you out.

Tom: All right. Jason Zweig had something in the Wall Street Journal just in the last couple of days. I'm just trying to encourage people to remember the Alamo, remember 2008.

Brendan: Be humble just in general about what you think is going to unfold. So the tagline on this story that he wrote is that if your memory minimizes how much you lost in the last bear market, you can easily overestimate how brave you will be in the next one. And so he said, at the end of 2009, investors looking back on the prior decade saw that U.S. stocks had gone nowhere, value shares had outperformed growth, small stocks had done better than large stocks, international stocks had beaten U.S. companies, emerging markets had earned higher returns than developed markets. To layer on top of that, the expectations at that point in time, 10 years ago or so, interest rates would rise, inflation is going to return, the dollar is going to weaken, commodities will boom, and U.S. stocks will continue to struggle. I think that instead of listening to all of that, people should have done the old Constanza rule from Seinfeld.

Tom: Just do the opposite.

Brendan: Literally done the exact opposite, because that's what we've had now for a decade.

Tom: Yeah, 10 years.

Brendan: Interest rates fell to historic lows, inflation all but vanished, dollar strengthened, commodities languished, U.S. stocks earned among the highest returns they have produced in any decade, bonds did well, growth stocks beat value, large stocks beat small, and shares from the rest of the world lagged behind U.S. markets. Literally the exact opposite.

Tom: Just literally exact opposite of what everyone predicted 10 years ago.

Brendan: Right. And so I think the message is, that what we just rattled off, what is now unfolded for the last 10 years, it's really easy to just assume that that will continue forever. And in certain cases it seems that way, especially like the U.S., international thing, just seems like there's no let up to this and that, like why would you ever own international stocks? Well, 10 years ago everybody wanted to know why in the world you would own U.S. large cap stocks. Why would you ever do that? You need to own small cap value and emerging markets.

Tom: Same thing, a little more than 10 years ago, real estate was expected to continue growing to the sky. And if you didn't have money in multiple homes, you were doing something wrong.

Brendan: You were a sucker. Everybody's getting rich and you're not. You know the Bitcoin article that came out in like January of 2018?

Tom: About two years ago.

Brendan: At the peak.

Tom: Yeah. Everyone's getting rich and you're not.

Brendan: It sounds ridiculous, and we like mock that headline, but that feeling encapsulated is the demise of all investors all the time. It's the worst feeling in the world. You think that everybody else is getting rich and you're not, and you would better do whatever they were doing.

Tom: There were so many smart people 10 years ago who said with all of the activity that the federal reserve is now doing, pumping money into the economy, that we are going to have massive inflation.

Brendan: Bill Gross, amongst others on the record saying that not just massive inflation, hyperinflation. We're going to be Venezuela, basically, was like the gist of some of these doomsday scenarios and nothing could be further from the truth. This is like the decade of low inflation.

Tom: I've said this on so many podcasts and so many videos, that I was told early on in my career that if we ever get into a period where we have low steady growth and low to no inflation, it's Nirvana for stocks. And the whole time this has happened in the last 10 years, everybody's complained.

Brendan: Right. Nothing but complaints about GDP growth not being as high as it used to be, and inflation not there so interest rates have remained low, but I would be cautious to at, we're seeing all these lessons now. You know, "Oh, they were totally wrong. Here's what actually happened." I wouldn't take that as gospel to say that what has happened now for 10 years will continue either. We could be just as wrong if we're assuming that low inflation continues forever and U.S. always outperforms international and big stocks are better than small stocks. That's not going to last forever either, so maybe the message is that-

Tom: Things change.

Brendan: Nothing lasts forever. And you should be humble when you're putting together a mix of investments to serve the fact that we don't know what's going to unfold.

Tom: You know, reading that article that Zweig wrote, it got me also thinking about, early on we used to onboard new clients and we would ask them about risk, about the actual risk management that they could take. How do you feel if the value of your portfolio dropped by 10% and most people would kind of like rub their chin and say, "10% is okay." And then we would say, "Well what about 20%?" "Well, I guess 20% is okay too." But now we do it in actual dollars so people can see, hey, a 20% drop is this much. And I think that if you ask people, "Hey, how did your portfolio due in 2008, 2009," we're going to get all kinds of crazy answers.

Brendan: People rewrite history and talk about how they sidestepped the entire thing.

Tom: Well they do it mostly in their mind. Because they say, "Well, I didn't lose 40%." Even though that's what the S&P 500 did. So I think people tend to forget over time, it's not as fresh in their minds anymore. And so the numbers get cloudy too. It's good to remember history.

Brendan: Yeah, it's impossible to remember it as it was. But if you can try to place yourself in the moment and be as honest as possible and try not to look through your prior self or your prior portfolio with rose tinted glasses. Try it because you got to be honest with yourself about what you're actually comfortable losing. Again, we also discussed that that's like one component of the risk equation, all right. So what are you comfortable with? But also, you have these goals. What are we going to need to get there and what can you realistically afford to lose without blowing up the entire thing?

So we've got those three components of risk and that's how we come to something that hopefully is comfortable for people. But yeah, that's a tough one, trying to be as honest as possible. And I don't think people do it intentionally, I think that we all rewrite history in our minds all the time.

So maybe a good way to think about it is just like, if you remember something, put a little bit of a negative spin on it and assume that it was that instead of what you actually remember. Yeah.

Tom: It's so interesting to read this article, and we'll link to it in the show notes, that every one of these fears that Zweig mentioned in his article became a headline worry for people in 2009 and very few of them even bubbled up to the surface.

Okay. Thanks again for tuning in to episode 288 and we will catch you on the next episode.