What Do You Say to Worried Investors? - Transcript

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Tom Mullooly: Welcome to the Mullooly Asset Management podcast. This is episode number 298. Your trustee co-hosts are here. Brendan Mullooly, along with myself. Tom Mullooly, Brendan, hello.

Brendan M.: Quite the week we're having, huh?

Tom Mullooly: Yeah, I'm glad it's Friday. Okay. Brendan, let's begin. What do you say to the person who's got money in the market and they're worried?

Brendan M.: I think that it's totally normal to be worried. I don't see how you could watch what's going on in the market these days and not be worried or nervous to some extent, scared. I think those are all normal reactions, but I also know that when we're putting together investments for clients, any money that is needed or even could be needed, possibly be needed over the next one, two, three years is not at risk in the market. It's in stuff like bonds, it's in cash. It's there and ready for them because those are the type of investments that will hold their value right now while the stock part of the portfolio does the scary stuff. But we also know that if we give the stock part of the portfolio three plus years, the odds of us being in pretty decent shape are good, but they're good if you hang tight. If you freak out and do something rash in the heat of the moment like this, you don't earn the average long-term returns from stocks that we all hear about.

Tom Mullooly: Why? Why is that?

Brendan M.: Because if you sell now, you're taking unrealized losses that aren't locked in yet. Making them permanent and then also putting the weight on yourself of having to decide later when it makes sense to get back in. I got to tell you, it's not going to feel any better when the market does find the bottom because we don't know when the bottom is. We can only see it in hindsight and the news is never all rosy. We're not going to wake up one morning and just be like, oh, guess what? We're 20% higher in a day.

It's a process and it's not going to feel like it's getting better and then before you know it, it is and you probably missed out on a bunch of the recovery, so I get it. It would probably feel great to dump some investments during a week like this and just put the money in something safer. But if that money has a horizon longer than a year or two, you're actually putting it in something more risky because you're putting it in cash and that's risking the future dollars that you need to spend down the road 5, 10, 15 years from now, they won't be growing anymore.

Tom Mullooly: But Brendan, what if somebody were to say, well look, things are really volatile right now. I think I'm just going to sit this out and then when it looks like the market's getting better, yeah, I'm not going to get the exact bottom, but I'll get back in. Why isn't that a game plan?

Brendan M.: Because I don't think they will get back in.

Tom Mullooly: I think that's a big part that never gets discussed in any of the financial media is that if you're at the point where you feel like you need to rip up the script right now so that you'll feel better about being out of the way of a tornado, just explain to me how a few weeks from now or a few months from now, you're going to feel differently that, yeah, now I feel better and it's okay to get back in. I don't see that happening.

Brendan M.: Right, and nobody in the history of investing has shown a reliable ability to get out and into stocks on a consistent basis. Some people might guess and get it right a couple of times. Nobody can reliably do this time after time and all you're doing then if you're getting in and out is probably costing yourself some of a recovery in between where you had to sit out until your feelings got you back into the market.

Tom Mullooly: So we've had a couple of quotes. In fact, I just wrote this morning about Ben Graham and some of the things that he's said. One of the things that he said, and I actually put it in the blog post, was that as an investor you need to become accustomed to the idea that your investment is going to fall by 33% or more at least once every five years.

Brendan M.: I think it's important to consider though that for most people that means the stock portion of their portfolio.

Tom Mullooly: Right.

Brendan M.: And I think something that's important right now for people who are nervous, who are scared, is to try as best we can to remember the feelings now when stuff is really going poorly so that when we do see stocks recover and portfolio balances get back towards where they were before all of this, you can make some adjustments if you decide, hey, I was able to ride that out but man, that really made me sick. That was a little too much for me. And you can put that into the context of your financial plan. Like what are you going to need from your portfolio? And maybe now after going through something like this, you have a better idea of what you can stand in your portfolio.

I wouldn't let it scare you too far in the other direction, but at the same time, I do think that these kinds of markets teach people what their real risk tolerance is and we try as best we can to simulate that and to have discussions with clients about it but there's no substitute for experience. And if you've experienced something that just was unbearable to you, I would say that if you can resist the urge now is not the time to be making these course corrections. But when we do arrive at a better time to do so to try to remember these feelings because these are real lessons and sometimes it's really hard to remember how you felt in the moment. I think you can learn a lot from this about how much risk you're taking and what you're truly comfortable with.

Tom Mullooly: Charlie Munger also had a similar kind of quote, I think he was kicking around the number of 50% draw downs.

Brendan M.: Right. He talks about this all the time as does Buffett who are both some of the biggest names who will tell you what I said before that nobody can reliably jump in and out of stocks over time. Anyone who says they can is full of crap and he said that you need to be all right with your holdings getting cut in half. And that he and Warren Buffett have seen this in their own portfolios multiple times over the course of their investment history as partners and that's kind of the price of admission is more or less the gist of what he has to say on that topic.

And I think everybody nods their head and says, that sounds great when they're just reading quotes like that but then when it's happening in real time, they're like, oh no, I can't handle this. Yeah, this is what it meant? Oh, I thought it meant something else. We're not even close to those kinds of levels yet of what Munger's talking about. But I think these percentages that we're talking about here and the regularity at which they occur, it's important to stress that that's for the stock side of your portfolio, so if you can't handle your entire portfolio going down 50% then you shouldn't be 100% in stocks.

Tom Mullooly: So that leads to another question. The other side of the portfolio, which is usually invested in bonds or some mix of cash and bonds, we expect that bonds will do well when stocks are not doing well and that has pretty much been the case over the last few weeks. But we've seen some extremes now in the bond market with some of these yields. Early February we saw the yield on a 10 year treasury around 1.5%. At the beginning of the selling it got to 1.3% which seems kind of normal because people were moving out of stocks and moving into bonds over the last couple of weeks we've seen some even more extremes, you want to talk about that?

Brendan M.: Yeah, so we've seen yields drop, what? Another 75 basis points from there. I mean what are we? We're above half a percent but we're below 1% on the 10 year.

Tom Mullooly: So 10 year is around 0.83 at the moment, but there was a time just a few days ago where the yield on the 10 year treasury, 10 year treasury got to 0.55.

Brendan M.: When we're talking about high quality fixed income like treasuries, the best predictor of future returns if you're investing in a mutual fund or ETF, individual issues maybe not as much, but you take the starting yield and that's probably going to be what your annualized return is if you're buying a 10 year treasury at 83 basis points, you should expect to get something around the 83 basis points per year from that investment. There's going to be some fluctuation due to interest rate movement over that 10 year period but at the end of it, if you take care of return divided by 10 it's probably going to be pretty close to that starting yield.

Tom Mullooly: That's such a good rule of thumb and most people don't even understand that when they're investing. So just to rephrase that, if you get started with a bond fund and the current yield is 2% that's probably one you're done with this investment, looking back, that's probably what your average return is going to be.

Brendan M.: Only works for high quality stuff.

Tom Mullooly: Right.

Brendan M.: If we're talking about junk bonds, high yield bonds, corporates, it becomes less so. But if you're talking about investment grade corporates, definitely, like U.S. treasuries.

Tom Mullooly: So what does that mean when there's bond investments that last year returned 7 or 8% even though the yield was say one and a half or 2%. Some other bond investments that through the first 10 weeks of this year have already returned 5 or 6%.

Brendan M.: Yeah, I mean look at zero coupon bonds are trading like tech stocks in the 90s. They're up 70% on the year or some crazy stuff like that. Well, it just means that yields have continued to fall and that's a combination of the fed cutting rates over last year and then now, just last week.

Tom Mullooly: Right.

Brendan M.: And also market action. So people are buying bonds, meaning prices are rising while yields are falling.

Tom Mullooly: So, let me see if I get this straight. So people are streaming out of stocks at low prices and they're going into bonds at high prices?

Brendan M.: Yeah, so what they're doing is they're selling an investment while it's down considerably and when the stock market goes down, this is the important thing to remember, the expected returns, what we can expect from them moving forward moves up. So yes, you're taking it in the short term, but because you're taking that hit, the returns that you should expect moving forward are now higher and the reverse is true for bonds. If we're buying bonds and the prices are rising in the short term it feels great, but the starting yield that you're collecting is falling over that period of time while more and more people buy bonds and your expected returns are falling in tandem so you're selling an investment when it's about to do well on a move forward basis and you're buying one that has done well and will probably do less well on a move forward basis.

Tom Mullooly: I mean, I don't want to just repeat what you said, but it's so important that people understand this. When the market is falling and people are panicking and making bad decisions and selling, they're locking in these losses. They're getting out of an investment that will now have a higher expected average return going forward and they're going into something like bonds which have already appreciated in price. So there's less money to make there and actually a higher chance of loss by going into something like that.

Brendan M.: Mm-hmm. Yeah, I mean I think it's important to consider stocks and bonds in the context that we're usually talking about them, which is as a blend in a portfolio because it's definitely true when you're looking at 10 year yields where they are today that bonds on a real basis, so considering inflation, if you're buying a 10 year treasury at today's yield, even if we have low inflation, which we have inflation, inflation is probably going to eat up all of the return that you get on a bond like that at this point.

Tom Mullooly: Even if we have the inflation rate that we've had for the last 10 years, which everyone says has been low ...

Brendan M.: Right.

Tom Mullooly: ... we've been getting the 1% inflation.

Brendan M.: It's still higher than ...

Tom Mullooly: Higher than what you're going to get.

Brendan M.: ... 80 basis points if you're buying today. So, these things serve different roles in the portfolios. The bonds are not your hedge against inflation. They never really will be. If you're looking for real after inflation returns, that's what you have stocks for. Bonds are there to be a ballast in the portfolio and to lower the volatility and to allow you to be opportunistic. If you're supposed to be in a portfolio that's 70% stocks, 30% bonds, and we've gone through a month now where the S&P 500's 25% off its highs, if your portfolio is drifted and it's only 60% stocks and 40% bonds now, it allows you to be opportunistic if you can stomach it and rebalance back to your 70, 30 target. Meaning you're going to do the opposite of what we just talked about. You're going to do the wise thing, which is you're going to take some money from bonds, you're going to put it back into stocks ...

Tom Mullooly: And some pretty good prices.

Brendan M.: Right. So you're going to take it out of something that's appreciated and who's expected returns have now fallen and you're going to put it into something that has depreciated, but it's expected returns have now risen. Again, this should be something that you shouldn't be changing your risk tolerance to get aggressive necessarily, but if you already had a plan that you should be at a certain mix and you've drifted far enough away from that and it's still sensible, then get back to that mix.

Tom Mullooly: What would you say to someone who has owned bonds and now they've appreciated greatly in recent times, but the expected return or the expected yield going forward on this is going to be equal to what we might get on a CD? Would you suggest selling or changing the investments to do something like that?

Brendan M.: I don't know. I think you could, depending on the bonds that you have, you could decide that you don't want to take the interest rate risk of owning longer term bonds right now because they're not paying much more than shorter term bonds. But people will tell you more frequently that you can't time the stock market but then say that they're going to tinker with their bonds mix because they know for sure what's going to happen with interest rates moving forward. But what they're doing is timing the bond market and I'm not so sure that anybody has a great ability to do that either. It's a little more straight forward than the stock market because bonds are more based on math and less based on feelings in the short term as stocks can be.

Tom Mullooly: And a fundamental story changing with a company's stock.

Brendan M.: Right.

Tom Mullooly: Right.

Brendan M.: But I would be wary of going overboard with that. Like if you had long-term treasuries, I wouldn't pull them all out and put it into a money market fund. If you had long-term treasuries, didn't you have them for a reason?

Tom Mullooly: Right.

Brendan M.: And one of the reasons is probably because they're the best hedge historically for stock market volatility because the long bonds are the most sensitive to interest rates and if interest rates are falling, people are piling into bonds then you get the most offset. Those are the bonds that are up the most. Zero coupons are up the most because they're infinite maturity.

Tom Mullooly: Right. The longest maturity without the current cashflow that you would get from a coupon.

Brendan M.: Yeah.

Tom Mullooly: Is there anything else that we ought to be mentioning or bringing to people's attention now as this market's starting to hopefully seek a bottom at these kinds of level?

Brendan M.: Yeah, I think ultimately paying attention to how you've felt throughout this entire ordeal now. It's been really fast, and I think that the velocity of the selloff is definitely contributing to the magnitude in terms of just freaking people out.

Tom Mullooly: It's pretty amazing to see. We hit an all-time high on February 19th and today we're at 25% lower and today we're recording this on March 13th.

Brendan M.: Right.

Tom Mullooly: Not even a month has gone by. Normally it doesn't work this way.

Brendan M.: Mm-hmm.

Tom Mullooly: And one of the questions that's come up this week is what was different in 2008 between 2008 in a market like this. I would venture to say that this market is behaving more like the market I saw after 9/11, where we had a catastrophic event come out of the blue, really wreck the markets for a couple of weeks and then things recovered and business got back to normal. It did tip us into a recession. Even that you could see things unwinding as time went by. This really kind of came out of nowhere in that sense and so quickly after reaching an all-time high.

Brendan M.: So just another important concept I think is, this is another riff on a Ben Graham and we've talked about him and Munger and Buffett earlier on the podcast and you wrote about his idea of Mr. Market today, but just to play off of that, people who feel an urge to react or to do something at this point in time, I would say just hypothetically consider here that you bought a house for million bucks, right? And you put 20% down on it when you made the purchase, if somebody knocked on your door a month or two later and said, I'll give you $800,000 for this house, you would laugh at them. But that's the proposition you're facing right now with your stocks. A month ago they were worth X and now somebody just meaning there are people out there, somebody is offering to buy them from you but now it's for 25% less than what we said they were worth a month ago. I don't know. I mean that doesn't really seem like a great deal to me.

Tom Mullooly: Unless you had a reason to sell.

Brendan M.: Yeah, if you have to sell because you need the money to do something else with and then sure, but if you have no reason to sell, no one's forcing you to, why would you do it? I don't know why you would accept that offer.

Tom Mullooly: Unfortunately a lot of people aren't even thinking when they're doing this. They just see this action on TV and they say, I have to do something.

Brendan M.: I think we forget too because it's just clicking a button on the computer now and we don't actually meet face to face like you would maybe with a real estate transaction or something like that, but somebody is buying your shares if you are selling them. If you want to go sell your stocks today ...

Tom Mullooly: People forget this all the time. There is another side to the transaction. Someone is buying what you're selling.

Brendan M.: The shares aren't just disappearing into the ether, that's not how this works. Somebody is buying those and you've got to consider why they would be doing that. The investments are so rotten that why would they want them? They might have more information than you. You might be trading with a gigantic institution or a hedge fund.

Tom Mullooly: Yeah, you don't know the reasons why they're there out in the market buying. Probably looking for bargains and probably to take money from you, money that rightfully belongs to you.

Brendan M.: Well, what's the quote? In bear markets, shares of stock get returned to their rightful owners?

Tom Mullooly: Yes.

Brendan M.: It's true.

Tom Mullooly: It's very true. Well, this has been one of the better episodes that we've recorded. This is episode number 298. Thanks again for tuning in, and we will talk to you on the next episode.