Is Leverage a Good Investment Strategy? - Transcript

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Tom Mullooly: Welcome back to the podcast. This is episode number 306, the Saskatchewan episode. I think this is our first Canadian episode.

Tim : Yeah, you were right. I remember at the end of last week's podcast, you guessed that it was Saskatchewan and it turned out you were right.

Tom Mullooly: Yeah. Too many hours cold calling back in the 80s and 90s taught me these different area codes.

We are recording this on Friday morning, May 8th, 2020. Tim this morning we got maybe the highest unemployment rate that we'll ever see in my lifetime and yours.

Tim : Yeah and I think the speed at which it happened too is staggering. This morning we got the April numbers for unemployment. We've been getting the weekly jobless claims. I think the total number of jobs lost in the month was 20.5 million unemployed. I think it was 14.6 something-

Tom Mullooly: Right, that was the unemployment rate. By comparison a month ago, the unemployment rate was 4.4 and that was up from something in the threes in February.

Tim : Yeah. I think the number for a lot of people, it's not surprising, but it's still definitely a staggering eye-opening number and it's very real for a lot of people out there. So it wasn't a shock to see the numbers this morning, but it was still kind of like wow.

Tom Mullooly: And to clarify, Tim says it's not a shock because we saw these weekly jobless claims that come out every Thursday. Those are the initial jobless claims that are reported every week from the week before. Now, even that number may not be accurate.

Tim : Right? It's tough to tell how reliable some of the numbers are when you constantly hear stories about, I know a lot of people in New Jersey are struggling to get through to the unemployment office and you've heard in other states that's the case as well. These unemployment offices are just getting flooded with calls and people trying to apply for unemployment.

Tom Mullooly: And their websites are crashing also.

Tim : Right. So these numbers might still be understated, but at the same time there are some states that are starting to reopen for business so there are people going back to work. So you have people not being able to apply for unemployment, but people going back to work. Some people coming off the unemployment numbers, people going on to it. It's a fluid thing. It's a moving target and I think it's hard to pinpoint the exact number.

Tom Mullooly: This is what I think the market may have a problem with a few weeks from now. You just pointed out that there are people who are still trying to file their initial jobless claims and there are people that started this week and going forward who are going to be added back, who were coming back to work and coming off unemployment. Out of the 20 plus million people who are out of work right now, we don't know what their percentage of that number is that are temporarily unemployed versus possibly permanently unemployed. Their jobs have been eliminated.

But the other issue is that the market tends to look ahead, and it's looking at good news and I think the presumption is the April unemployment report, which we got this morning in May, is probably going to be the highest rate we're going to see. I think the problem's going to be that if we show people coming off the rolls and more people coming on the rolls that we may have a number next month that's still 14% and I think the market may not be ready for that.

Tim : I think one thing that we pointed out in the Mullooly Asset show last week was that people are confused how the market is going up when the economic data is so bad. One thing I said in the video was how the economy and the stock market are not the same thing. They don't always walk hand in hand and move in the same direction. Sometimes they do, but sometimes they don't like they're doing right now. The market is forward looking in nature but it does bring up that question, if the market's forward-looking, what happens if the thing the market was looking forward to doesn't happen.

Stocks fell in anticipation of these jobless numbers. We all saw it coming and now markets have said to have been rising in anticipation of these numbers coming down or things going quote unquote back to normal. But what happens if that doesn't happen as fast as the market is anticipating? I don't know. It's tough to say. If someone were to give you the economic numbers for May in June, I don't think anyone would be able to predict what the market's going to do. I don't know. It's tough to gauge.

Tom Mullooly: Just to put it in perspective, I saw something last night on the news. Don't quote me on this, but reports were that there's essentially a million people out of work in the State of New Jersey, but the unemployment rolls only show about 700,000 people that have actually been able to file their claim, which means there's still another 50% that still have yet to even get through and file online or through the office.

Tim : It's going to be tough and it's hard to tell from stories like that if these numbers are going to be truly reflective of what's going on in the economy at the time. Things might start opening back up in the next month or two, but certain people might still be trying to get on unemployment while the rest of the economy is getting off of it, so it's hard.

Tom Mullooly: Yeah. The point is let's say out of the 700,000 in New Jersey that are out of work, let's say 300,000 get their jobs back. They were temporarily on unemployment, they go back to work and but now these other people are now added to the rolls and they're still a month from now 700,000 that are unemployed. These people may be long-term unemployed. And so this unemployment rate may not come down as quickly as some people might be anticipating. It could be a problem.

Tim : Yeah. We'll have to see what the market does in reaction to that. There's no way to predict what that's going to be like.

One other thing I've been seeing online and on Twitter about the numbers today is that people are making a lot of comparisons to the unemployment numbers from today versus other times in history when unemployment has spiked. The comparisons aren't pointless. I had that written down, actually I used the word pointless, but I don't think they are. I think they're good for perspective I guess in terms of magnitude, just comparing the sheer numbers of people, but we've never had a situation like this before in terms of this many people being out of work for ... We all know the reason why everyone's out of work.

Blair duQuesnay from Ritholtz wrote a piece calling it the No-Fault Recession. No one industry is at fault. You could look back at 2008, 2009 and pinpoint the perpetrators who caused a lot of the problems, but this time that's not really the case.

Tom Mullooly: It's a universal shutdown of the economy. So it really wasn't anyone's fault per se.

Tim : I just think the comparisons are, it's kind of apples to oranges in a sense.

Tom Mullooly: Sure. In 2008 real estate as an industry was pretty much blown up, banking blown up. There were lenders blown up. There were a lot of sectors that took years to come back.

Tim : And they were the ones who caused the problem though.

Tom Mullooly: Right. We had to go through that purge to get back on better footing. Now here we are in another situation where the economy is in a more than a pinch and we're starting to see some different kind of things coming out of real estate. A couple of different points of view.

Tim : Yeah. There was a Wall Street Journal article that was talking about why prices for houses aren't coming down and people might have anticipated that that be the case. The article was talking about and it makes sense, demand has dried up in the housing market, but at the same time, supply has also dried up too. The reason that a lot of people aren't dropping the prices for their homes that are listed right now is because one, no one's in a hurry to move. I mean there's so much up in the air right now with everything else going on in other people's lives add moving and trying to sell a house and move into a new house to that, that's just not something people want to do right now.

Also the sellers are under the impression that the reason they're not selling their houses and getting offers right now is because of the pandemic and because people can't go on as many open houses or go check out the house in person and not necessarily that the house is priced incorrectly whether that's true or not.

Tom Mullooly: Well, I also know that real estate transactions go through a very long pipeline, and so the sales reports, the numbers that are being reported in April are actually from transactions that started in January and February and just went to close in March or early April. We haven't yet seen the impact of this pandemic yet in real estate prices.

The other thing is with people losing their jobs, there's always going to be some concern about what is this going to do to real estate. Are people going to need to move? One thing that I picked up on through 2008, 2009 and even into 2010 is that most people will do anything to stay in their homes. They'll skip out on student loans. They'll skip out on car payments. They'll change their lifestyle habits, but move out of their home, that is the last resort.

Tim : That's priority number one in terms of the hierarchy of paying bills. You got to stay in your house.

Tom Mullooly: The foreclosure process normally is also a long pipeline and now banks are being told that they must not foreclose on loans in the next few months, so we've made a long pipeline even longer. I think what we're going to find is in the next 12 months and maybe 18 months, we're going to see more people facing foreclosure or in a position where they might need to sell or possibly be more motivated to sell.

Tim : Yeah, I'd agree with that, and on top of that, once these stay-at-home orders are lifted, more and more people are going to be ... those people that were looking to sell their house or buy a new house before they were told to stay home are going to be even antsier to get things going, so it will probably come roaring back.

Tom Mullooly: But I think what's stopping it now in its tracks or what could be a showstopper is that lending is showing signs that it may be drying up. I think we both saw the article in Bloomberg.

Tim : Yeah. It kind of reminds me of, I don't want to let what burned me last time happen again this time. We were just talking about how the housing and the lenders are what caused the problems in 2008 and you don't want to let that happen again. People always talk about fighting the last war. You prepare for the last war and that's not really the issue. Yeah. Now people are in tune to that and they don't want to let it happen again, so it makes sense that mortgage lenders are a little hesitant.

Tom Mullooly: The headline of the article that we were both referring to is Mortgage Lenders Tighten Screws on US Credit in Echo of 2008, and it's right on cue.

One of the things that was highlighted in the article, there's no more cash-out refinancing at many banks. Now if you're a business owner and you've got some equity in your house, the only way you're going to be able to get that equity out of your house is to do a refinance where you actually get money out of the house. And for some business owners that is their lifeline.

Banks are already saying we're not even going to do that. I understand the bank's perspective because when you do a home equity, you're in the second position as a lien holder. So if real estate prices drop, there is no equity against the loan that you're providing, so it's a tough spot.

Tim : It definitely is for both parties. The business owners and people, they need money right now and they need this equity. But at the same time, if 20.5 million people just lost their jobs, how are they going to pay for all of this stuff? How are they going to pay for their mortgage if they don't have anything coming in? So it doesn't make sense from a business standpoint for mortgage lenders to be dishing out new lines of credit. It doesn't make sense. It's unfortunate.

Tom Mullooly: It is unfortunate. It's too bad because just as rates are reaching historic lows, nobody can borrow. I think that the government is rolling out program after program after program. They ought to put together a program at the federal level that backstops the banks and says, "Make home equity loans available to everyone and we will backstop the loans if they meet certain criteria just to start to get money flowing again."

So along those same lines, we talk about government programs. Interesting article on MarketWatch. This was just a couple of days ago, we'll link to it in the show notes, that talked about people need a way, like a method or they need a way to save for emergencies like this, like a pandemic emergency fund.

Tim : I saw the article and my initial thought was, I think there's a gift out there. It sounds good; doesn't work. It's a good idea, but I just don't see the people of our country buying into that. Right now, it sounds like a good idea because we're going through a pandemic, but when things reset, people aren't going to want money coming out of their paychecks for something like that.

I mean we already have government savings vehicles; 401ks, IRAs, 457s, TSP plans that aren't funded. They have vehicles available. So if they make something for a pandemic, I just don't think it would be adopted the way that it should be.

Tom Mullooly: You're saying it would be abused?

Tim : No, I'm saying it wouldn't be used at all. Especially they pointed out in the article how people who don't earn a lot of money, like low income houses should use something like this. It's like, the people who don't earn a lot of money are the people that need every single cent coming to them in their paychecks. Why would they want any percentage coming out of their paycheck? They need money on a day to day basis. So to sock something away for a pandemic ... They said in the article how they should have restrictions on what you can take the money out for.

Tom Mullooly: Well, you're already doing that for your 401k.

Tim : Exactly. So you want to take more money out of someone who already isn't making a lot of money ... they're already not getting by on a month to month basis on what they're already bringing in. It falls under the good idea category, but I don't think it would have the intended effect.

Tom Mullooly: I forget what episode it was, but it was easily three years ago where we did a podcast where we talked about there ought to be like a 401k at work, there ought to be some kind of universal savings program where before you are able to enroll in a 401k at work that you have money taken out of your paycheck with an employer match that goes into some kind of emergency fund. I don't know what that number is, it's $5,000 or something, but I think that there ought to be some kind of incentive for businesses to start doing this.

Then we get into that whole discussion of why is your employer responsible for your retirement and your health care and all that other jazz. But we have to help people get the basics. Saving for retirement is pretty useless if you can't pay next month's rent.

Tim : Right, exactly. Yeah, I think that the principle of what they're getting at is people need to save money for a rainy day. I agree with that. I don't have a better solution other than just telling people to put money in savings accounts. I just don't think that that idea is something that would be welcomed with open arms by a lot of people.

Tom Mullooly: I want to talk about something pretty juicy and that was right before we turned the mics on, we were talking about Michael Batnick's article.

Tim : He wrote a really, really good piece. It's a two minute read. It's very short, but it hits pretty hard about leverage.

Tom Mullooly: These are leveraged exchange traded funds.

Tim : Yeah. The first line of the post I think is the best. It says, "There's no investment strategy so good that it cannot be undone by excessive leverage."

Tom Mullooly: You can wreck anything with enough leverage.

Tim : Yeah. One of the last lines in the post kind of ties that all together. He says, "Leverage is the fastest way to go from good to great, but it's also the fastest way to go from good to broke." In the middle of the post he outlined one example. They get questions a lot saying, "If I'm a young investor with lots of time, I'm 25 years old, why shouldn't I put my money into a leveraged product?" He gave the example of in the last five years the S&P 500, he used the ETF SPY, was plus 75% over the last five years, which is good.

Tom Mullooly: Holy crap. Good? 15% a year.

Tim : Yeah. This is before the pandemic and before the market took a drop. It was plus 75% in the last five years. Then he compared it to the ETF SPXL, which is the S&P 500 bull three times leveraged fund.

Tom Mullooly: Before you even get to the numbers, let's explain what that is. It's the S&P 500 structured as an exchange traded fund where they basically load up on leverage margin to basically when you buy a share of this exchange traded product ... is it an ETN? Is it a note? I don't know.

Tim : It's an ETF.

Tom Mullooly: Okay, so it's an exchange traded fund. So basically you're using futures and options to lever up the portfolio, but the idea is that you're going to get, I'll say this real slow, three times the daily move in the S&P 500.

Tim : Right, the daily move.

Tom Mullooly: Daily move.

Tim : And it doesn't specify what direction that daily move is. The SPXL was up 240% before the market declined. So 240% in five years, pretty good, right?

Tom Mullooly: Sounds good.

Tim : In 23 trading sessions SPY was down 34%, which is a lot. SPXL was down 77%. You went from a hundred cents on the dollar to 23 cents on the dollar in 23 trading sessions. 77%. Michael said in the post, "There's no way to put that portfolio back together. You are blown up, sir. You're cooked. You're done."

And that's just an S&P 500 fund. There are people out there, a lot of oil leveraged funds have been getting a lot of attention recently. Specific sectors and specific commodities are even more volatile and even more hyper-focused than a broad S&P 500 fund. It just goes to show the power of leverage. And like Michael said, it can help you get from good to great, but it can also take you from good to broke very, very quickly.

Tom Mullooly: Very quickly. There's an oil ETF that was trading at, because it's split a few times, was trading in January at $500 and it's now trading around 16, 17 something like that. So yeah, this is what happens.

Tim : Yeah, that's the only example anyone needs to show how dangerous leverage funds could be.

Tom Mullooly: Now there have been times over the years where if you get a sideways market or a market that really doesn't have remarkable moves and you buy a two times or a three times levered product where the underlying index or commodity can actually be flat or up a little bit and you can lose money because it's a daily product. People just don't seem to grasp that idea. It's based on the daily move, so it's based on what happens between 9:30 and 4:00 PM.

Tim : People don't understand that ... I feel like most of these leveraged products are designed to be day traded.

Tom Mullooly: They are.

Tim : You don't hold a three times leveraged fund in your portfolio for five years.

Tom Mullooly: Oh my goodness, no.

Tim : If you do, you're crazy.

Tom Mullooly: You don't understand what you own.

Tim : Right. I think it was very, I'll link to it in the show notes, the chart is eye-opening. It was just a really good reminder of the dangers of leverage.

Tom Mullooly: When I got started in the business, I was told that the two areas where if you're a broker, you can expect complaints, is with options and with margin leverage. What I found with options is it's a lot like driving a car. If you're that five year old who's trying to go out for a ride in a Maserati, if you don't know what you're doing, you can really hurt someone and primarily yourself. Okay? But margin, you can be right in the idea as you just pointed out, you can be right in the idea and get destroyed permanently. So if people are buying a two times S&P fund or a three times S&P fund expecting, "Hey, I'm in my twenties I'm going to be investing for many, many years, why don't I just own this," even if the S&P were to get back to where it was in mid-February, this thing is not going to be back there. There is no way that that can happen.

Right, that's going to wrap up the Saskatchewan episode number 306. We appreciate you tuning in. Next episode, 307, we're going to be driving about 12 or 13 hours south to Wyoming for episode 307.

Hope to catch up with you then.