How to Lose Your Shirt in 10 Days With Leverage - Transcript

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Tom Mullooly: Welcome to the Mullooly Asset Management podcast. This is episode number 310. 310 is the area code for West LA. Pretty amazing that we're even talking about stuff like this because this is episode 310. That's a lot.

Tim Mullooly: It's a lot of podcasts.

Tom Mullooly: It is a lot of podcasts. 310, we were just talking before we turned the mics on about 3:10 to Yuma, which was a Glenn Ford movie from 1957. I watched it in black and white. It was remade 50 years later in 2007 with Russell Crowe and Christian Bale. Forgive me for not introducing my co-hosts. Brendan Mullooly is here along with Tim Mullooly, good morning.

Brendan M: Hey. So I think we saw an article this week about a guy who was bankrupted in two weeks and might be slightly a bit of a hyperbole there, but he was doing some pretty wild stuff it sounds like. And I wanted to play a little bit on that and you know that there's a movie, The Chick Flick, How to Lose a Guy in 10 Days.

Tom Mullooly: Yeah.

Brendan M: They should put a label on ETNs, how to lose your shirt in two weeks. That's basically what happened to this dude.

Tom Mullooly: But it was a lot of money. It was seven or 800 grand.

Tim Mullooly: Yes.

Tom Mullooly: And this thing essentially melted, it was one of these mortgage ETNs, right?

Brendan M: I just think in general, there were some red flags for me in terms of the terminology being thrown around either by this guy or the reporter, probably some combination of it. But the guy claimed to be playing catch-up using products like this in terms of trying to make up lost ground from either not saving enough or making up lost ground from being in other wild investments that took him down in a market downturn. And I just think that idea is so dangerous. And even with regular investment products.

Tom Mullooly: Don't do that.

Tim Mullooly: Yeah. Not even mentioning three times leveraged products, just trying to-

Tom Mullooly: Well, wait, let's back up and let's share some of the story with folks so they understand this is not a traditional exchange-traded fund that invests in an index. Tim, you mentioned that it's a three times...

Tim Mullooly: Yeah, it was some kind of three times leveraged ETN. So it's not even capturing just the daily moves of a regular investment product, it's three times both up and down. We've talked on a number of different podcasts about the dangers of using leverage. It's dangerous enough to try and, like Brendan said, play catch up in your retirement savings with non-leveraged products. But to add that three times to it is adding gas to the fire.

Tom Mullooly: It's also important to note that this is an ETN, which is an exchange-traded note. Very, very, very different from ETFs. I had multiple cringe moments over the last 10 years when I would tell folks that they're invested in an exchange-traded note, not an exchange-traded fund. And they would say, "ETF, ETN whatever." My response is always, no, you don't understand. And the difference between an ETF and an ETN is gigantic, because an ETN, an exchange-traded note is actually an obligation of the issuer.

And so there were plenty of ETNs that were trading in the market in 2007 and 2008 that were issued and backed by Lehman Brothers. That became a flashpoint for a lot of investors. It's pretty scary. But again, this points to people piling into stuff without any kind of understanding of what they're getting involved in.

Brendan M: The understanding is obviously not there because these are really complex products that people in our industry don't even fully understand. And that's not to fault them or anything, it's just that these things are ridiculous. They come with 100 page booklets and literally nobody is reading them before they put money into it. I don't care what they say.

Tim Mullooly: Yeah.

Brendan M: By doing that, using these vehicles alongside the mentality of needing to... It's a whole mindset of having to make up ground. When you're in that kind of desperate mindset, you're going to make really bad decisions in terms of investing. And you're basically the person at the table, at a casino whose down, who just ran to the ATM so that they can make bigger and bigger bets so that they can get back to even. And I just think, if that's a framework that you're operating under for investing, you're setting yourself up to lose. You need to have a more well-developed plan than that.

Tim Mullooly: I think also working against this guy, I think one of the first things they mentioned was how he had used something similar in the past and it worked for him back in 2008. So he did it again. It's kind of the beginner's luck, overconfidence, like, "Oh, it worked for me the first time. It's going to work for me again." And that's not always the case.

Sometimes we say, the best lesson that a new investor or someone can learn is to lose money on their first trade real quick so that they can experience that. You put something to work one time and it works, you feel great. You feel like, I'm smart. I did something right. You try and duplicate that again, you think it's going to work and it doesn't.

Brendan M: Yeah.

Tom Mullooly: I'll put it in my 15 second public service announcement, in the middle of this. My very first option trade in 1986, worked out great. I proceeded to lose $30,000 trading options for the next year. Just a horrible, horrible year I'd like to forget.

Brendan M: There's something else in the article too that, I think either last week or the week before, we were talking about on the podcast. And this, again, may have been something that's being interjected by who wrote the article or, again, it could have been something generally that they were talking about with the people that were interviewed. But just the notion that the Fed gets blamed for people using products like this because, the quote from the article was that they're pushing investors into a risky hunt for bond-like products that could offer higher returns.

The author, obviously, letting us know that these things are risky, but if you ever hear the phrase from somebody that something is bond-like, but has the ability to offer you higher returns, just runaway. That is nonsense.

Because along with the possibility for higher returns, you have to acknowledge that there's a commensurate risk of lower returns too. And you need to understand both sides of that coin because if you're fixated on the idea that you might make higher returns but you're not acknowledging that, you could get wiped out to, I think you're setting yourself up, to use a product you don't understand and it could be like this.

Tim Mullooly: And they were saying how the banks and the brokerage firms, the products are being advertised that way too. They said they're offering both steadier payouts and more lucrative than investing in index funds and stuff like that. To a certain extent it's on the banks. And the brokers and they do get sanctioned and regulated for not educating their investors before people put money into it. But honestly, I feel like it's just a drop of a hat for them. In the article they said, Wells Fargo agreed to pay $35 million in settlements. For a firm like Wells Fargo, $35 million, that's nothing for them.

Brendan M: Yeah.

Tim Mullooly: Yeah. They're getting sanctioned for what they're doing, but is it really affecting... They're not going to stop doing it. Then they're turning around and doing it with a different product.

Yeah. They're making more money By continuing to get people to put money into these things and have to occasionally pay a settlement or two. Their business is still operating. Yeah.

Tom Mullooly: One interesting point, I'll just piggyback on what Tim said, is that there is no advisor, no broker involved. This gentleman did this trade himself at his online broker. And now he is suing his online broker to say, "You didn't give me any kind of warnings on this." Sorry, when you're doing this yourself online, you bear all the responsibility and all the risk.

Tim Mullooly: And I think we said it on a podcast a couple of weeks ago or Brendan said it, but people get prospectuses and all these big 100 page booklets on stuff. But it's like the terms and policies for an iPhone, for an Apple thing. You just scroll through it and click agree and move on. No one actually reads it anyway. So they might have offered him the information he was looking for and he didn't read it.

Tom Mullooly: When they start to read it-

Tim Mullooly: After they've lost. Yeah.

Tom Mullooly: Yeah. When they're down 25%, then it's like, where is that thing? I got to find it. And you start reading it and you just get this sick feeling in your stomach like, wait a minute. The original issuer can just cancel this exchange-traded note? What? Are you kidding? This thing went down to 25 cents.

Brendan M: I think there's an element of these things being complex that makes them appealing. Because they're complex, and then the tagline that gets attached to them is bond-like product that offers more upside and it's very complex. And so it maybe gives off the aura of like, hey, I'm smart. I deserve to use a complex product like this and beat everybody else. I'm the intelligent person who discovered this thing.

Tim Mullooly: It has to be complex. It can't be that simple to make money. Yeah.

Brendan M: Exactly. It's like, it's complex. And that's why I'm the only person who's found this great opportunity or I'm so great that's why I'm being offered this by an advisor, if that's how it's going down. And it's just, no. Risk and reward cannot be detached from one another. If there's the opportunity for a greater upside, the opportunity for greater downside exist alongside with it. You can't have one without the other. And if anybody tells you otherwise, they're full of crap.

Tom Mullooly: I can't underscore enough these two times and three times levered funds. They're getting better at getting this point out to people. These are meant for daily moves in these underlying indices or products that they have. They're not meant to be longterm investments. They're meant for day trading or short term swing trading. Where are you going to be moving in and out of these things in a period of a couple of days, maybe hours. Right. It's not something that is going to... You're not going to buy it in January and sell it in December. It shouldn't be.

Brendan M: Entirely beside the point of even if you're using them as they're intended to be used, you should really be questioning, all right, whatever the underlying is here, whether it's oil or bond yields or whatever, it's like, do I really have a view on this particular thing that expires in 24 hours? Because-

Tim Mullooly: Or less.

Brendan M: Yeah. That need to be the case for you to use a product like that. And so, I don't know. I think that's a pretty ridiculous thing to think about. Do I have a view on the direction of interest rates that expires in the next 24 hours? And do I need to use this vehicle to make a bet on it? I don't. That's ridiculous. I think if you think that then you may be diluting yourself into how much insight you have into the underlying,

Tom Mullooly: Well, when you talk about having a view, there've been plenty of people this year who've had lots of views on the market's going to do well, or the market's going to struggle or we're going to have a period where things are really going to be down. And everybody with a view has been wrong so far. And we're only into the first week of June.

Tim Mullooly: Yeah.

Tom Mullooly: Ben Carlson, from the Ritholtz gang wrote a piece, which we'll link to in the show notes, massive up and down moves in stocks in the same year are more common than you think.

Tim Mullooly: Yeah. I feel it's natural to look at what's happened in the market so far this year and just be like, gosh, we can't have ever seen anything like this before. This is crazy unprecedented times in the market. And Ben's point was that it's a little more precedented than you think. It doesn't happen every year that you see a 35% drop followed by 40% rally, but it has happened.

Tom Mullooly: People most of the time shake their heads when I tell them that in 1987, the Dow Jones was up for the year. It was up a little over 5% for the year. But in October of that year, the market fell 22% in one day and people just can't believe, that must've been the worst year ever. Well, actually no. The market was up almost 40% at its peak. Yeah. These things do happen. We also saw it in 1998 where the market was moving along. We had about a 30% drop in the middle of the year due to the crisis, Du Jour, and Fed stepped up to the rescue and the market finished up for the year.

We've had plenty of times where the markets have had a big move up and finished flat or a big move down, like this year, and we seem to be rallying. So we're almost halfway through the year. Right now, I think the Dow and the S&P are probably down two, three, 4% or something like that. We could finish up for the year.

Brendan M: I think the thing here is that there are a lot of examples of this happening over history, but what might lure us into thinking that it doesn't happen very often is that we just pay attention to the averages over time.

Tom Mullooly: Right.

Brendan M: And so you think about the average market returns, really mask the year to year volatility of having money in stocks. And JP Morgan puts out they're a guide to the markets, I think quarterly. And there's a really good chart in there that I like a lot that shows, across time, it'll show you average from each year, but then also it shows you a range of up and down in terms of where it was during the year based on the path it took.

It illustrates a little bit better the range of outcomes, because I think the range of outcomes is what scares people and the range of outcomes it's what makes our job tricky. Is because you have to consider that having money in stock seems like a bet. That is good over the long term and I really believe that it is, but you can't have all of your money that you're going to need tied up in something like that because you're going to have experiences regularly like what's happened this year where, if you needed money in April and you had all of your money tied up in stocks-

Tom Mullooly: You're screwed.

Brendan M: You were well off of in the highs and you got to be thinking to yourself like, sure, I need the money but do I really want to sell my investments right now? Because they're still down 15, 20% from where they were earlier this year and that's the tough decision to have to make. You don't put yourself in those positions by acknowledging the fact that, yeah, this is regular, what we're seeing this year. This kind of volatility is why stocks give a premium over time because they take really scary paths to average their returns over time.

Tim Mullooly: Yeah. I think people think that it needs to make sense too. And that was one of Ben's points at the. He said, one of the things that I've just come to understand is that the market doesn't need to make sense. It doesn't need to move in the direction that everyone thinks it's going to. Even when everyone thinks one thing is going to happen, there's always the possibility that something else could happen. At the bottom in March, I'm sure there were a very small minority of people who thought, were going to come literally straight back, uppercase V on the charts and his point that it doesn't need to make sense.

Tom Mullooly: Yeah. As humans, we try to rationalize everything in our brains and try and make sense of things that happened. Just listening to what you were saying a moment ago, though, makes me think about, as time goes by and you look at these historical returns for stocks, it makes me think about, to make it even simpler. Baseball and football, the teams that you follow, you may say, "You know what? That guy came up and he was over three with three strikeouts and he left nine men on base. But then in the ninth inning, when we really didn't need a head, he got ahead." But then all of a sudden, a week later, they're like, "This guy is on the 12 game hitting streak." It doesn't always line up the way. Or someone could basically hit a swinging bunt, it looks like a frozen rope in the box score.

Brendan M: Yeah. I was just going to use that terminology because they get a hit for that, but the stat in the box sheet doesn't tell you the story of being there in real life. And so yeah, we can look back and say, "Hey, in 1987, the market was up." But that doesn't tell us that we were up 40% and then took a nosedive 20% in one and to finish at that point. In hindsight, it's like, hey, investing is easy. You could have made money in 1987. All you had to do was not freak out.

Tom Mullooly: You just don't know by looking at the box score, we're just looking at the standings. We're just looking at what the annual returns were for the Dow Jones or the S&P. First of all, that's not your portfolio. It doesn't tell you what happened that year. Some folks will look back and they'll be like, "Market goes up every year. The last few years." In a conversation, and you're like, you think about the rollercoaster ride that you've been on.

Brendan M: There were plenty of opportunities to not, or like, if earning market returns were easy, then people wouldn't need so much help investing. But the hard part is just earning what the market is willing to give you. The market earns good returns over time, but people don't really achieve those returns because it's not easy. That's not to knock anybody, it's just that it's really difficult to just earn, let alone the idea of outperforming the market, just earn what the market has given us over time. Is really hard because we have stuff like this year were we're down 35% in a matter of six weeks, and you're questioning whether what you're doing is right or not.

Tom Mullooly: Sure. So Tim, most of these market predictions are based on interest rates and earnings from companies. And you pointed out an article this morning about Barry Diller.

Tim Mullooly: Yeah. He was on CNBC and he was talking about how his company or companies are no longer going to be participating in earnings guidance or providing guidance. It was a four or five minute segment on CNBC where he was talking about why it's, he called it absurd practice of earnings guidance. And he was just saying how companies spend so much time and effort and money to massage the earnings and the projections and the models to get them just right so that they can beat the earnings.

But sometimes even when you beat the earnings, they don't beat them by enough and the stock goes down and then you have to project out for future quarters. And, to him, he was like, "It doesn't make any sense. It's futile." I kind of agree with his idea of the whole thing about beating earnings versus estimates versus what actually happens. It doesn't make a lot of sense and I don't know what the alternative would be, but I kind of agree with him that this whole earnings guidance thing seems kind of silly at times.

Tom Mullooly: And Barry Diller is no slouch. He's owned a lot of media companies over the years. He owns Expedia. He also owns a company called IAC. And years ago, that used to be, I forget if it was Ticketron or Ticketmaster, but now they own IAC, owned Match.com, they own HomeAdvisor, they own Vimeo. He's 100% in the online world. And so trying to predict from this 90 day period to the next 90 day period, what our quarterly earnings are going to look like, it's hard. It's very hard.

Brendan M: I think all of this stuff, it came from a place that is helpful. Because when you run a business, you do need to project what business revenue and earnings and profits are going to look like into the future. And so if people are investing in your company, they probably want to see that sort of information too, like any business owner would. That's what you are when you invest in a company, you're part owner of the business. But it got away from being informed about the business that you're investing in and you're giving your capital to to be used. And it got more into this gamification of, we're going to beat it by a penny and then the algorithms are going to bid the stock up or down. That's-

Tom Mullooly: Microsoft was the best at that. In the 90s, every quarter, they would beat by one penny.

Brendan M: It's engineering. And so I don't think it's actually serving the purpose that it should or that it was designed to do. And so I don't know if just saying-

Tim Mullooly: And that point too. He was like, it started out in the right place, but it's become something that it wasn't supposed to be.

Brendan M: Right. Because, yeah, people do need to have information of, why would they give their money to a company if the company was going to say like, "Hey, we're just a black box. Give us your money and we won't tell you anything about what we're doing in terms of the company and what we think and where we're going."

Tom Mullooly: This conversation just kind of triggered something in my memory. Just a couple of days ago, I listened to our friends at Morningstar interview Charlie Ellis, not that long ago. And he talked about how Wall Street used to be closed to the general public in the sense that they would invite people from their investment banking firms in and talk about how their businesses were going. Analysts were eventually hired to basically do the homework on what could happen over this quarter or in the next quarter or in the next year with a particular company.

And then in the 90s, we got Regulation FD, which basically said, if you're going to have any kind of business disclosure, it has to be disclosed fairly to everyone. And that's why everything gets put out on the internet now or on Twitter. But I think we're getting to a point when we see companies, like Barry Diller's companies and a few others that were also mentioned, where they're saying, "Hey, you know what? We do want to do this." And I think it's time that maybe the analysts do a little more homework.

They've been, basically, given the answer by the company. We think we're going to be in the range of 40 to 42 cents this quarter. They don't have to do anything. They're just reporters. Do some homework, do some analysis and say, "Hey, you know what? We don't get information from the company, but this is what I see." I would pay for that kind of research. And that's what Wall Street used to be about a long time ago.

Brendan M: Well, but Reg FD was so that people weren't trading on insider information. That wasn't necessarily about that.

Tom Mullooly: Was a byproduct. Yes, you're right. So...

Brendan M: Yeah. I think the information should be out there. I just think we should be more intellectually honest about what it is. When we build financial plans for people, we have to do projections about the future too. And we're very open and I'll even call them during our meetings. These are educated guesses about the future. I'm not telling people, we act as if these earnings things are the truth. This is what's going to happen next quarter and then we freak out in either direction if it's not exactly what they said it was going to be. But it was just a guess. And there's there's no shame in that.

Tim Mullooly: And they change their guesses all the time too.

Brendan M: Right. Because things change over the course of a quarter. Next quarter you come out and you guess again and it's guiding you in a general direction. It's not supposed to nail everything. We can have the information be disseminated to everybody and the companies can put out guidance but we should just be honest about what this information is. It's not foolproof it's just a guess.

Tim Mullooly: Yeah.

Brendan M: That's it. And so use it as you will. If you want to use this guess, then just be open to the idea that it's a guess and it maybe wrong.

Tim Mullooly: It reminded me of that post that Josh wrote, Josh Brown-

Tom Mullooly: Thank you for bringing that up because I was going to mention it too.

Tim Mullooly: It was called, the thing that bears hate the most. And he gave the example of, so there's a company whose stock is at $50 and their earning estimate is 50 cents. And then they come out and say, hey, something what happened in the first or second quarter of this year. We cut our earnings projections from 50 cents down to 35 cents and then the stock goes from 50 to 40. But then when they come out and instead of 35 cents, the real number turns out to be 37 cents then the stock goes from $40 to $70 past where it was. And it was like, wait, they originally were going to do 50 cents and they only did 35. It's like, well, they revised it down to 35 and they gave 37. So it's good or it's better.

Tom Mullooly: It's not a right or wrong number, it's the difference between better or worse. Yeah.

Brendan M: But, yeah. I agree. It's like, okay, what do these numbers actually mean and how are we going to use them? Because companies can revise and set their own projections and estimates and sometimes it doesn't even matter. Sometimes it's not even directionally the way that you think it would go. Because sometimes a company will say, earning our quarterly guidance is X, and then they exceed that and the stock price goes down for a totally different reason. So maybe-

Tim Mullooly: They didn't exceed it enough.

Brendan M: Well, no. Maybe they'd be this quarter, but then they gave the guidance for the following year and they said that it's going to be down from there. It's like, okay, we cleared this hurdle that we thought was going to be the problem. Maybe we invested on that because we had a hunch or we did the research to show that they were going to beat that number. Let's put our money to work in this thing. And then when we do, there's an unknown that we couldn't have foreseen and so we did what we thought we were going to do, but the outcome was different. I just think that people making decisions based on this sort of information are out of their minds.

Tom Mullooly: I will say that Bill Gates and Steve Ballmer invented this in the 90s. Where they would beat the quarter by a penny, like clockwork, and they would talk down the next quarter.

Like, "Oh, next quarter, we don't have much visibility. It's not, we don't know. It's going to be bad. We want you to bring the numbers down." They were masters at that.

Tim Mullooly: Smart.

Brendan M: Yeah.

Tim Mullooly: If they understand that that's how it works-

Brendan M: They know the game. They know that at this point, even though they're the-

Tim Mullooly: And that's what it is.

Brendan M: ... Insider of insiders here, they can't use nonpublic information anymore because of Reg FD, but they can do other things to play this game and be successful at it.

Tom Mullooly: Well, that's going to wrap up episode 310. 3:10 to Yuma, make sure to check it out. The black and white version or the color version. Both good. Thanks for listening. And we will catch up with you in the next episode.