Debunking a Myth About Active Management - Transcript

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Tom Mullooly: Welcome back to the podcast. This is episode number 319 of the Mullooly Asset Management podcast. I am Tom Mullooly and joining me today is Tim Mullooly.

Tim Mullooly: Hello everybody.

Tom Mullooly: Tim, we both read a post from Larry Swedroe.

Tim Mullooly: It was on the evidence-based investor. So Larry looked at the performance of active management during this recent COVID-19 crisis. Mostly because there's this continuing myth, so to speak, that active managers have higher fees because they outperform in bear markets. So it's justifying a higher fee because you get the outperformance while the markets are going down. So Larry wanted to take a look at that because we got a pretty textbook case of a bear market and a subsequent rally in a span of a couple months during this year, he wanted to see if that myth was actually true or not.

Tom Mullooly: And the results were for us pretty much what we expected, but for many others in the business, not what they expected.

Tim Mullooly: Yeah. I mean to us, it confirmed that active managers don't necessarily have the secret sauce that can protect you every time from a bear market. They actually, Larry quoted a study, they looked at the current quote crisis period was, they looked from February 20th through April 30th because that's when the market peaked. And April 30th we got a little bit of all of that rally through April after the market bottomed in March. And it essentially put the March 23rd bottom, right in the middle of that period.

Tom Mullooly: Right. Which is historically a super small window. If you go back to the 1930s and some draw downs that we saw in the 1950s and 60s, those were measured in years, not weeks. And just for all of our listeners, when we talk about active management versus passive management, most exchange traded funds are considered passive investments because they mirror an index. And so the index might make changes once a year or not even that frequently. And so you're buying a basket of stocks and you're basically holding that basket throughout. You can decide, oh, I don't want to be in the semiconductor basket anymore, so I'm going to change, pick up my money and go somewhere else. But an active manager is Donny day trader. He is out there saying, I know when I should be zigging instead of zagging. And so you do pay up, you have higher fees, higher costs that come with active managers. And the pitch was always that, well, these guys are going to bail you out in bad markets.

Tim Mullooly: The study that he looked at used a morning star database of about 3,600 mutual funds and the results that they found were, 75% of the actively managed mutual funds that measured to their benchmark of the S&P 500 underperformed. So three quarters of the active mutual funds underperformed the index-

Tom Mullooly: The index itself.

Tim Mullooly: That they were supposed to be measured against. And the average under-performance was about 5.6%.

Tom Mullooly: That's a big whiff

Tim Mullooly: So it wasn't really that close, 57.6% of mutual funds that measured to FTSE/Russell benchmarks, they underperformed so, over half of-

Tom Mullooly: So the FTSE Russell indexes will also measure large cap indices, not exactly the S&P 500, but they'll also measure mid cap, small cap, some of the international markets.

Tim Mullooly: I think they wanted to just include multiple different benchmarks. They had factors in there too and they also pointed out that there was a study from Vanguard that lasted from 1970 through 2008. Just the general conclusion from that study was that through that time period, during bear markets, the factors of cost, security selection and market timing for active managers was a very hard hurdle for them to jump over. There were occasions where active managers did outperform, but it wasn't the majority by any means.

Tom Mullooly: And the group that outperformed last quarter or last year is not guaranteed to be the same group that's going to clear the hurdle this quarter or this year.

Tim Mullooly: Yeah. There's very little consistency from bare market to bear market. So they wanted to include that as well, because that's a much longer span of time, as opposed to just this one past crisis that lasted two months or a couple of weeks in terms of what they were measuring.

Tom Mullooly: I think it's so important that when you're putting together a portfolio that you understand what criteria gets your investment included in the basket. One of the reasons why there's a lot of talk about this, active versus passive is because I believe I don't have any data to back this up, but I believe that active managers, so mutual funds with managers that are going to be-

Tim Mullooly: Bobbing and weaving?

Tom Mullooly: Right. That they are mostly sold investments. They're sold by brokers. I did it for a long time early on in my career when I was a stockbroker, is you would hear these wonderful stories about these managers who survived the '72 to '74 bear market. And now it's a chance for you to get in not just as a private money management account, but now you can buy their mutual fund with a 6% sales charge.

Tim Mullooly: Right. I agree that it feels like a sold thing. But those managers, they might have actually performed really well during that bear market, that one time. But it doesn't necessarily mean that they know what they're doing for the bear markets to come in the future.

Tom Mullooly: That's right.

Tim Mullooly: So you're paying for their past performance and you're going to get future results. And it doesn't really add up.

Tom Mullooly: So when you look at active managers, structured in a mutual fund for most individual client, you're going to find that you'll have a mutual fund, may or may not have a sales charge built into their price structure but they'll also have what they call 12B1 charges. That's the section of the SEC act that allows them to charge for marketing expenses. And the brokerage firms are pretty good at stuffing a lot of things in that channel. And so the expenses for 12B1 expenses can be pretty high. Then you have to pay your star mutual fund manager on top of it. And so when you start to look at some of these actively managed funds, you'll see that the annual expense ratio, on a bond fund could be anywhere from 50 or 60 basis points up to 1%, one full a hundred basis points. On equity funds and certainly small cap and international funds, you're going to find that the management expenses are way beyond 1% or more than a hundred basis points a year.

Now, you compare that with buying the small cap 600 index or the midcap 400 index, or even the ex US international markets. And you're going to find that there is no superstar manager that they have to pay because they're just buying an index. And so the costs, the management expenses that are built into these exchange traded funds are sometimes single basis point like less than 10 basis points. I know that the S&P 500, you can buy it for three or four basis points, three or four basis points, that is 0.03%. Also, when these ETFs hypothecate, when they lend out these securities, they actually make money lending the securities out. So it's practically free when you look at it that way, but you don't have to pay for these superstar managers because they're not really bringing home the bacon.

Tim Mullooly: Right. Yeah. It dispels that myth, that outperformance is going to be there. It might end up being there once or twice, but it's not going to be consistent outperformance while the market's going down. Don't mean to just completely dunk on active management, but I think it's worth noting that, I think to me, it just means that fees are really important. Because a lot of times active or passive, if the market's going down, that investment is most likely going to go down. But where you're going to see savings or relative outperformance is at what you're paying in fees. Because you could save yourself a percent just by choosing more of an index fund than something actively manage, you're paying that fund manager.

Tom Mullooly: Right. And so, like I had mentioned a few moments ago, a lot of the, I don't have any data, but I have to believe that the majority of actively managed portfolios, mutual funds are sold by brokers. They get paid to sell these things. I think if you're a fiduciary investment advisor, like Mullooly Asset Management, we want to pay attention to the costs that our clients are incurring. And we want to keep them as low as we can.

Tim Mullooly: Right. Because we don't see any of that for us. So it doesn't make a difference if the fees are high or low, we want to keep them as low as possible.

Tom Mullooly: And we found that there really isn't that much more value delivered by hiring an active manager, whether it's hiring an individual manager or going through his or her mutual fund. Hey, this morning, right before we turned on the microphones, we got the unemployment report for July. Now, a little tidbit of information that I think a lot of people overlook is that when the government reports, the department of labor reports the unemployment rate for July, today's August 7th, how did they pull all that data together in just six days? That doesn't make sense. So what most folks overlook is that when you get the employment report, it is from the middle of, in this case, the middle of June to the middle of July. And the number is always reported the first Friday of the following month. So this data is already three weeks old. So in June, the unemployment rate was 11%, I think it was 11.2. Unemployment rate this morning at 8:30 was 10.2, so the overall estimate was 10.6.

So the number came in a little better than expected. The July nonfarm payrolls, the change in the number of jobs showed an increase of 1.8 million jobs. The reality is that that is not necessarily new jobs being created. That is people returning to work. The U6 number, which is the total number of people unemployed last month in June, was 18 million, today it's 16.5 million. So there are some indications that the economy is healing, but overall the number was okay. It continued to show that the labor market didn't get any worse.

Tim Mullooly: I think that's an important point. Because the numbers themselves are still very high, 16 million people is still a lot of people, but it's good to see that it's at least moving in the right direction in comparison to previous months. So I think that's the important point.

Tom Mullooly: You're right. I agree with you. And I think it's important for people to understand that when they do measure the unemployment rate, we're talking about a total number of jobs that they're aware of, is somewhere in the vicinity of 155 million jobs. So that's how they get this unemployment rate.

Tim Mullooly: And we've said it before on other podcasts, it's always a moving target. And like you said, the number is already a couple of weeks old. So when these numbers come out, it is to an extent squishy, but just the general direction that the numbers are trending, I think is the more important point than what the actual down to the last digit number is.

Tom Mullooly: I know I said on a podcast back in April in the middle of this pandemic, that if we got to an unemployment rate, somewhere between nine and 10%, by the end of the year, that's good. And that's actually the range that we got to in the 2008 recession, we got to 10% unemployment, but we didn't get to that rate until late in 2009.

Tim Mullooly: In comparison to that crisis, things in general just seemed to be moving a lot quicker. I mean, if you go back to even, we've talked about the response from the government, the fed, the stimulus, everything, it was a lot quicker. So not surprising to see other areas moving quicker than they did back in 2008, 2009 as well.

Tom Mullooly: They did a lot of things and I know if you're binge listening to the podcast, you're hearing the same message that we mentioned two episodes ago and I think four episodes ago. But the federal government has continued to learn from past mistakes that we need to get money into the system and that we need to get money, in this particular case, get money immediately into the hands of the people who are out of work. And so sending these stimulus checks out and sending the unemployment, I don't know what you call it, but these extra payments that just stopped, getting that money into circulation has helped keep people going. And there've been a lot of scholarly studies over the years that say, giving money to the banks is good, but we really need to get money to the people who are hurting the most. And that is into the consumer's hands so that they can continue to put food on the table and keep the lights on. Speaking of keeping the lights on-

Tim Mullooly: Good segue.

Tom Mullooly: Thank you. We have lights here in the office. We had a tropical storm that blew through here Tuesday, mid-day. Our lights here at the office flickered, we lost power for maybe five or 10 minutes. But lights came back on, they've been on ever since, but I live about four miles from the office and we have not had power now since noon on Tuesday and it's Friday morning.

Tim Mullooly: Yeah. It's wild how, it wasn't really that to me seemed like not really that drastic of a storm, it blew through in almost like an hour and a half. But it seemed to have done a lot of damage in the surrounding areas. I know people in other towns that also don't have power, but my house, a town over, has power. So-

Tom Mullooly: Brendan still has power?

Tim Mullooly: Yes. This doesn't seem to be any rhyme or reason for it. I guess you can't really predict where the trees are going to fall on the power lines beforehand. You just have to see what happens afterwards. But I know that this whole situation of not having power for a few days sent you into research mode in terms of looking into the utility companies and maybe there's something that they could do so that we don't lose power for days at a time, every time we have a storm.

Tom Mullooly: There's a question that I want to put out to the universe and I'm searching for an answer for this, but I haven't really found one after several days of looking this up. We all know in the business that electric utilities pay pretty generous dividends. What I want to know is why, why do they do that? So I understand that when we're talking about electric utilities, they're regulated, they're regulated by the board of public utilities. So they are restricted in terms of how much they can charge their consumers, businesses, and residents for delivering electric power to their places. When they want a rate increase, they have to go before the board of public utilities and they have to give the reasons why. But when you look at the balance sheet, as I did for FirstEnergy and some of the other utilities here in New Jersey.

You start to see that, FirstEnergy has close to a billion dollars in long-term debt, when they have these power outages, especially once due to storms like hurricane Sandy and this one, it seems to me like they're not actually doing positive construction to mitigate damage in the future, they're really just doing repair.

Tim Mullooly: Yeah. They're just reacting to what happens, they're not taking preventative measures to stop it in future cases. They're just reacting to what has already happened.

Tom Mullooly: Years ago, we had an office on route 71 in Manasquan and my office overlooked route 71. And after hurricane Sandy, we were back in our offices and I'm not trying to dunk on the linemen that we're doing the work, but they basically were just looping wires on the polls. The polls never came down the wires slumped, so they needed to be restrung, they needed to be reconnected, but they didn't really do anything. And if you actually drive along in this area of Monmouth County, Belmar, Wall Township, Manasquan, Spring Lake, Sea Girt, you'll notice that most of these polls that are up are holding a lot of wires and they just seem to be, they didn't repair them. If you look at a picture from the 60s or 70s, you're going to see a couple of lines running through a power line. Now, you'll see 50 lines and it looks like a spiderweb way up on a pole. Nothing's been done, but yet the utility needs millions and millions of dollars every year in increased charges to us for repairs, not for any long-term projects.

So this is what I'm getting to. Why is it that these utilities pay big dividends, I mean a yield right now on FirstEnergy stock is over 5%. It's pretty good. They pay just taking $1.56, a share in dividends times the number of shares that they've got outstanding, which is about a half a billion shares. They pay $843 million a year in dividends. Now, it's been seven plus years, almost eight years since hurricane Sandy, that's $5 billion in dividends that they've paid out to shareholders. Now, I don't want to make this into a social issue, but who owns FirstEnergy stock? People who can afford to be in the stock market. So we're talking about one percenters or people who are a little better off than most. Don't you think it would be a better use of some of their money, not all of it, but some of their money to reinvest into maybe putting these wires' underground or doing something else?

Tim Mullooly: Yeah. When you started talking about this topic a couple of days ago, it got me thinking, why don't they do that? And unfortunately, I think it's because they don't have to, if you live in this area, it's not like you can just unplug your power from JCP & L or from FirstEnergy and go take your business elsewhere. There is nowhere else that you're going to get your power. And it feels like they know that. So these people don't have any other options out there. So yes, they're regulated in how much they can charge, but it's still a monopoly in the sense that there's no other competition out there. So they don't have to worry about the people that they're actually supplying power to. They're more interested in padding the pockets of the shareholders and keeping them happy and keeping the share price elevated. Because they know that the everyday person who might not be as a shareholder, but uses their power, they don't have anywhere else to go in terms of powering their house or getting electricity. It's unfortunate.

Tom Mullooly: It is unfortunate. And I also believe that a lot of their debt that you'll find on the balance sheet is really old debt that's been rolled over and refinanced now at lower rates. And so this, there was a time in the 60s and 70s, when your dividends that you would get from utility were considered a return of capital. Under the old tax laws, that was actually a pretty nice deal and it made utilities really popular as investments because they were stodgy, they didn't move that much. They tended to pay higher dividends as they still do and you got a little bit of a break on this. And so that was really a nice deal, that doesn't exist anymore. Some dividends from electric utilities are considered qualified dividends, but we're really splitting hairs now. What we're really talking about is the capital structure, why is it that these companies need to pay out a $1.55 or $1.56 per share like FirstEnergy does. I don't understand why we have to keep things as they are. Why can't they reinvest some of this money into maybe retiring some of this debt?

Maybe prepaying their pension plans, maybe instead of putting it back into the shareholders pockets and we're shareholders too, because we own this through ETFs, but maybe they take some of this money and they put it into fixing their physical plant.

Tim Mullooly: Yeah. It just doesn't seem like there's any incentive for them to do that. It's like for them, it's working for them. And it feels like it doesn't matter to them, if people are out of power for a couple of days, it might not be the case, but that's just the feeling you get. It's like, well, what else are you going to do? Where are you going to take your business? So for them, it doesn't seem like there's an incentive and pretty much all electric utilities across the country have these big dividends. So for someone to be the Guinea pig or be the first one to be like, hey, we're going to completely wipe out our dividend to use it to make long-term preventative repairs and maintenance on our actual power lines and increase our service, while the customers might be happy the stock price is going to tank if someone does that. I wouldn't want to be the first utility company to try that out because it could end up very badly.

You could cut your dividend, the stock price could tank. You could end up having to file bankruptcy and it could just blow up in your face, even though you were trying to do the right thing and actually increase your service.

Tom Mullooly: The common stock of a company like that will tank because it's doing something that other companies, other peers, the peer group, are not doing. However, I think that more people in the market will look at this and say, this is a very good thing, they're being proactive about managing their balance sheet. And all you have to do is look at a couple of local cases to see when do these utilities file bankruptcy when it's the worst possible news out there. Yesterday, we were talking about Long Island Lighting, when their evacuation plan for the Shoreham Nuclear Power Plant didn't get approved by the State of New York. Their dividend was in jeopardy. The stock was trading about 10 or $11 prior to that, when their plan didn't get approved, all of a sudden it was like, wow, we have $7 billion on our books that we may have trouble paying that debt, we're going to eliminate the dividend. The next day, the stock opened at $2. And Long Island Lighting doesn't even exist anymore. But even a more recent example, Pacific Gas and Electric in California.

I think if they spent a little money on maintaining their systems and trimming trees around their wires, or they may have had these wildfires that they've had the last two years out in California. If you don't live in California and haven't really been following that story, some of these wildfires burn down towns, people died because they couldn't maintain their equipment. It doesn't take much it's regular maintenance, that is something that should be part of your income statement and ultimately then part of your balance sheet. Why is it that they run the risk of, hey, we're going to just continue to pay out our quarterly dividend instead of maintaining our equipment, maintaining our wires, trimming trees and avoiding places where there may be possibility of a fire. It's terrible.

Tim Mullooly: It is. And I think it's because there's no other competition to force them to make any changes, so maybe that's where it starts.

Tom Mullooly: I will say that it's just one guy's opinion. Since hurricane Sandy, at least here in Monmouth County, it doesn't appear to me that Jersey Central Power and Light or FirstEnergy, the parent company out of Ohio, they used to be called Ohio Edison. I don't believe they've done much in the way of improving the infrastructure. It's been band aid after band aid, after band aid. I've noticed since hurricane Sandy, that when we do get these tropical storms or these bad storms that come through, power in Monmouth County and other surrounding areas is out for days at a time because our infrastructure is simply falling apart. So I think there has to be some element of competition or a way to get these utilities, to wake up to the idea that they don't have to pay out a big fat dividend every quarter, they could be putting a little more money back into their business.

That's going to wrap up the Mullooly Asset Management podcast for this week, episode 319. We appreciate you tuning in and we will catch up with you on the next episode.