Politics are Not in the Portfolio - Transcript

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Tom: Welcome back to the podcast. This is episode number 320. Thanks again for tuning into the Mullooly Asset Management podcast. I am Tom Mullooly in the thunder today. Joining me is Brendan Mullooly and Tim Mullooly.

Tim: Hey everybody. This is Tim. I know that we've been getting a handful of phone calls over the last couple of weeks about the markets and the impending election, and our thoughts on that. So, I know, Tom, you've been fielding a lot of those calls generally-

Tom: Wearing the flak jacket.

Tim: Yeah. Generally, is there just a message that you would like to get out there to everyone listening to the podcast?

Tom: It's going to tie into the video that we recorded yesterday, and I think we should link to it in the show notes as well. But the message that I've been sharing with folks is, so far this year, we've gone through a global pandemic, 150,000 dead alone here in the United States, 20 million people out of work. I mean, a lot going on and the market is, essentially, where it was last year. Now I think that alone is kind of fluky, that the market is where it is. And I think a lot of that is driven by the Fed. We never really know, as Brendan always points out, we never know the reasons why the market does what it does.

But the big message in the video, and please watch it, it's only a couple of minutes long, but the big message was, focus on things that you can control. You can't control the stock market. You can't control this election that's coming up, that everybody is freaked out about. If the market didn't go down the drain with all this other bad stuff that happened in the front end of this year, why are we worried about an election?

Brendan: I just think to your point, you rattled off a bunch of bad stuff that's already happened this year. And like you said, in the video, if you rewound the clock to the end of last year and said, "Hey, this is what's coming in 2020, we're going to have a pandemic. And all these terrible things are going to happen as a result of it. What do you think?" I think most people would have said, "Let's back up the truck and buy puts, or let's put everything into cash." And they would have been totally wrong. There was no reason to do that. Aside from the volatility, like you said, basically where we began the year, I don't think that's fluky. I just think that's how the world works. It's completely unpredictable.

So we could have the answers to the test, meaning this pertains to the upcoming election too. We could have the answers to the test. Somebody could tell us right now that they just traveled back from the future, and that they know Trump wins, or they know Biden wins. What are we supposed to do with that information? Because the stock market isn't going up or down based on that, it's based on people reacting to that, and you never know how people are going to react to information, and it's not always intuitive. If you rewound the clock to 2016 in the summer and said, "Guess what? I'm back from the future, later this year, and you're never going to believe this, Donald Trump is going to win the election." You would have, again, backed up the truck and bought puts, or put all your money into cash. And that was the wrong move too.

Tom: I agree. And there's something else though. We mentioned this too in a couple of different media spots. We've heard from people who have said, "I just want to sit this out until after the election." What makes you think the world is going to be right the day after the election, or the week after the election? Because after the election results come in, 50% of the people who voted in this country are going to be upset that their guy lost. This madness is going to continue. This hatred that we see on social media, that's not ending, that's not going away. So these are the terms for our playpen.

Brendan: I'd also like to add that none, absolutely none, not a single one of our client investment portfolios was built upon a thesis of Trump being president, Biden being president, Obama being president, Bush being president. That was never, ever baked into how we construct our portfolios, never entered the conversation. All that we know is that, over the course of an investor's lifetime, every four to eight years, we're going to have somebody new in charge, and they're going to have their own set of policies and things that they want to accomplish when they come into office. But we need to get portfolios that are going to do what clients need them to do over the long run, which is support their lifestyle and retirement, provide them with an income. That has proven to be something that is attainable for people, regardless of which party or person controls the White House, or Congress for that matter.

Tim: Yeah. We always say that we have a rules based approach to investing. One of those rules is not whether there's a Republican or a Democrat in the White House. That's not how we do things. And like you said, people who want to wait until things go back to normal or until things calm down. They never calmed down after the 2016 election, there are still people that are upset about what happened. And I'm sure if you go back to 2012, there were still people going into the 2016 election who were unhappy with things that went on. To say that you're going to sit out until the election passes and when the sun comes back out and everything's clear, I don't know how many times we have said that there's never an all clear signal, you need to operate under the conditions that we're in, that this is normal, today, it is normal.

Tom: Risk is where you get the return and you have to have some risk. There are going to be periods of your investment time horizon where we're down. And there's going to be somewhere we're violently down, like we were in February, March. We have to know your situation and then we can take the proper amount of risk.

Brendan. You and I have had this conversation a lot where people that wanted to get out of the markets, prior to the 2016 election, when was the right time to get back in? Because different

sectors took off the day after the election and we went through a rotation and then we got into 2017 and look what happened to the market.

Brendan: I'll also say that even after elections, we had a reaction... There's going to be reaction to the results of the election. Don't get me wrong. I'm not trying to tell people that the market isn't going to move based on that. I'm telling you that-

Tom: It will move.

Brendan: ... it's impossible to know beforehand which direction it's going to move in, or which parts are going to move and how they're going to perform, and we don't need to successfully do what we're trying to do for clients. The sectors that moved after the election in 2016, ended up being not the place you wanted to be for the entirety of the four years Trump has been in office because, at the beginning it was like, "Oh my god, this guy won. We weren't expecting it. What are the things that he wanted to try to do again? Oh, these things." And people did stuff like piling money into banks because he wanted to roll back regulation. And they've been an under performer for four years now. So even if you know, "Hey, wow, this guy just won and hey, he really wants to do stuff to help this specific sector." You could load up on it and be totally wrong because it just hasn't worked out.

Tom: Yeah. Tim, how many podcasts, videos, and posts have we put together here at Mullooly Asset where we talk about don't let your emotions get in the way of your investment plans.

Tim: Too many. I have lost count over the years, but I think the important thing to remember is that, for clients listening, that's why you have us, that's our job, is to make sure that we can stand in the way of you letting your emotions get the best of your investment decisions. So if we sound like broken records trying to repeat the same message over and over again, it's because we are in a sense, we're just trying to drive home the most important points that it sinks in. And it's really tough to control your emotions. I'm not going to sugar coat that. So, I think it's worth repeating over and over again.

Brendan: It also feels different every time.

Tim: Right, there are going to be people that-

Brendan: So, we've literally heard from people, we've given them the spiel and then they say, "Yeah, but..." And they tell us why this time is going to be different. And I don't think it's going to be, I think people are concerned about the potential for taxes to go up. How many times have tax has been cut or raised over the course of your investment career?

Tom: I can't keep count.

Brendan: Right. So, that is going to occur. It is a virtual certainty that tax policy will change in the future and there are going to be repercussions of that. However, we don't know them beforehand, and even if we did, we wouldn't know exactly how the market reacts to them or if it does at all. Even if we were to assume that today, let's assume for rock solid certain that what

people are saying is true, that if Biden gets in taxes are going up, what are you supposed to do with that information? Does that mean you have to sell your stocks? I don't think it necessarily does.

Tom: I don't think it a knee jerk reaction that has to happen.

Brendan: And is it even going to occur after the fact? Once he's in office, will he be able to get that through? I don't know. Neither do you.

Tom: The news cycle used to be a lot slower pre-internet and so, the day or two after the State of the Union speech, the market would just go berserkowitz because there was... The president would get on TV and say, "We're going to do this. We're going to do that. We're going to do this." And for a couple of days, all these sectors that were sleepy came out of nowhere and they did great. It's the same kind of knee jerk reaction when we saw banks... Banks did great for two weeks after the election-

Tim: And then did nothing.

Tom: ... in 2016 and then they did nothing. They did nothing. So I'm going to steal a phrase from Josh Brown. Basically for younger folks in the market, you should almost hope for some kind of pull back in the market because it will be a great opportunity to put money to work.

Brendan: And I think for people who aren't younger and who are older, relying on their portfolios for income, I think they also need to remember that we didn't build their portfolio upon the assumption that we were never going to have another bear market. Our retirement income plans account for the fact that we are going to have periods of time where stocks are down and they may be down big and we need to still fulfill the income requirements that our clients have to continue living their lives. And we construct a portfolio to take all of that into account. It doesn't require timing the market, hopping in and hopping back out again based on anything, but especially not on election results.

Tom: Yeah.

Tim: So, on this hand, we have people calling in that are nervous about the election and maybe the market going down. On the other hand, we have had some people suggesting that they want to get even more concentrated in stock positions and they want to buy some of these stocks that you see in the news and put a big percentage of my money into one stock. And there was a good article in The Wall Street Journal talking about the five myths of diversification.

Tom: Can I just say that was a beautiful segue.

Tim: Thanks.

Tom: That was fantastic. You're talking about the Meir Statman article?

Tim: Yes. Yeah. So, he wrote an article talking about five myths that you hear about diversification, reasons why you don't need to, or why it's not as beneficial as people would suggest.

Tom: So, if you're not familiar with Meir Statman, he's a professor of finance at Santa Clara, and he literally wrote the book on behavioral finance, behavioral investing. His first myth that he wrote in this Wall Street Journal article, and we'll link to it in the show notes, was diversifying beyond 12 to 18 stocks offers no benefits. He says that's a myth.

Tim: So there's a stat out there that says you get about 90% of the benefits of diversification by owning somewhere between 12 to 18 stocks, and he said that that's true, but to imply that you don't get any additional benefits from going beyond 18 stocks is not true at all, that's a complete myth.

Brendan: Yeah. And I mean, you're removing some of the specific company risks the more companies that you own. But I mean, that says nothing about if you have an 18 stock portfolio, but they're 18 large cap US tech stocks. That's not diversified.

Tim: Right.

Tom: No, it's not diversified at all and we're going to get to that.

Brendan: Yeah. I don't know. There are levels of diversification and yes, it's as simple as owning two stocks is better than owning one, and then three is safer than owning two, and so on and so forth. But yeah, I don't know. I don't think there's an upper band to that and I think that was his point in saying it.

Tim: Yeah, he was also saying if you kind of do DIY diversification and you just buy all of these stocks individually, the cost of diversification can be really, really high, but he contrasted that with there are low cost ETFs that do things very efficiently. So, if you're trying to diversify, you don't need to buy 100 different individual stocks or 1000. There's much easier ways to do that.

Tom: In previous times, we would sit down with new clients and go through the statements that they were bringing in and they would have basically three S&P 500 index funds, mutual funds in their account, or three technology neutral funds in their account, and they would say, "See, I'm completely diversified." What they didn't was, yes, their money was between a couple of different mutual funds, but within those mutual funds, they owned almost the exact same names.

Brendan: The number of positions in the account has no correlation whatsoever with the amount of diversification. I've seen accounts that are all in one fund, like a target date fund that are far more diversified than somebody who owns three stocks or something, or even a couple of different index funds.

Tom: Funny you should say that because that's actually myth number two. So, Statman wrote that owning a handful of stocks you know, is safer than a portfolio of thousands of stocks you don't know. What Brendan alluded to with the target date fund is that you've got a mix between

growth and safety in that you have money that sits in cash, in bond funds, and then other, on the growth side, you've got money that's invested in large cap funds, small cap funds, international funds. I mean, you're kind of all over the place with that.

Tim: Yeah. There was a study that he did quoted for this myth from the Journal of Financial Economics from 2018 that said the best performing 4% of stocks each year account for pretty much the total gain of the market each year, going back to 1926.

Brendan: So, we should just own that 4% and then we'll be fine, right?

Tim: Exactly.

Brendan: As simple as that.

Tim: The kicker there is though, I know you were being sarcastic, but-

Brendan: Yeah. Tongue in cheek.

Tim: ... for people out there, you would have to know what that 4% of stocks is going to be and buy them ahead of time and do that consistently every year. The odds of doing that are almost zero.

Brendan: Right, it's called active management and its track record is super poor in terms of outperforming a basic index fund. So, short of having a crystal ball and knowing this stuff, as you said, in advance, or having somebody who can know it in advance for you and charge a reasonable fee that doesn't erode any benefit of knowing it then, yeah, I think you might be better off owning a diversified index.

Tom: So Brendan, you are teeing up every one of these because the next myth that he wrote about was that owning an index fund provides you with enough diversification.

Tim: There needs to be more to that statement. It's like we just said-

Brendan: It's just like what you just said, if you owned three index funds, but they're all S&P 500 index funds, you're not diversified, you just own US large cap stocks and you probably need some exposure to small and mid caps, maybe in the US and foreign and emerging markets, bonds in some capacity, if your risk profile calls for it.

Tim: It seems like there are more and more indexes getting created every day and they're getting more and more concentrated into very specific stuff than just a broad market index fund. So, to say just owning an index fund makes you diversified is not necessarily true. Index funds with 15 holdings that are all in the same sector-

Brendan: Exactly.

Tim: ... that's not diversified.

Brendan: Right.

Tom: The Semiconductor index used to have 100 stocks in it. Now it's got about 15 names. So a lot of them have been merged, acquired, or just put out of existence. So yeah, some of these indices are not really that broad based

Brendan: It's just marketing at this point. They take active products and slap the word index on it because it's what people want. It's in Vogue.

Tim: I think going back to a point from the second myth about trying to pick the winners every year, for the people that want to just own Apple or just own Amazon, if you own a fund that is diversified, you do own those stocks. I think that's something that we tell a lot of clients when they call in and say, "I want to own this stock." Or, "I want to own that stock." They don't realize that you already do have a position in it, it's just within this ETF.

Brendan: Yeah. Especially some of these bigger stocks, like two that you just alluded to it, Apple or Amazon. I mean, if you have a large cap US fund you should look under the hood because there's probably... Like if you have an S&P 500 index fund, you've probably got 6% exposure of... 6% of every dollar you have in that fund is tied to Apple.

Tim: Right.

Tom: Yeah. And then look at some of these technology ETFs, and you're going to find that the big names at the top, if they're not equal weighted then they're going to be-

Tim: They're big and getting bigger -

Tom: Yeah, that's right.

Tim: - percentage in these stocks. So the odds of you owning those winners every year go up or are better than having to pick them individually, but you're doing it in a smarter way than just trying to hand pick one or two stocks every year.

Tom: I think, in addition to being smarter, it's also safer. Another one of the myths that he talked about, kind of ties in with what we were speaking to when we started the podcast, that one of the myths he wrote is that market timing is necessary in addition to-

Tim: Having diversification.

Tom: Do we need to be all in all out at certain times?

Tim: Again, market timing is another thing that we've talked about a lot on podcasts and videos and how it doesn't add that much benefit, if anything, because you have to be right. If you're trying to time it, you have to be right going in and going out, if you're jumping from one fund to the other or one stock to the other, you have to buy it and sell it at the right time and it sounds

great to buy low and sell high, but a lot of individual retail investors tend to do the opposite just based on scary news headlines and how they're feeling that day.

Tom: I can say that in 35 plus years going all out was the right move one time. One time in 35 years.

Brendan: If you had four or five years, it didn't-

Tom: It didn't make a difference.

Brendan: Right.

Tom: It didn't make a difference.

Brendan: You still didn't have to do it. So I think that the point being, if you have money that you're going to be spending in the next couple of years, it shouldn't be at risk to the degree that you feel the need to then time the market and get out because you're saving dollars that shouldn't have been at risk anyway. So, I mean, if you had a couple of years, you didn't need to get out then either.

Tim: Yeah.

Tom: That's right. Okay. The last myth that Statman talked about in his article, US and international stocks are closely correlated. So, there's no benefit to diversifying into both international and US stocks. The first thing that people will say is, "Yeah, he's right. Because these S&P 500 companies get 50% of their revenues from outside the US." That's not necessarily true.

Brendan: I mean, it is true, but you're not getting... One of the additional benefits of international diversification is hedging currency risk. And so, depending on what the dollar is doing, US large cap stocks have tended to do fine in both rising and falling dollar environments. But the same can't be said for US small cap stocks, which tend to be much more cyclical based on what the dollar is doing, meaning strong dollar has tended to be better for US small cap stocks and the opposite, not so much. And that's more sensitive on the international side too. Developed countries tend to do better during periods of a falling dollar, but emerging markets especially tend to do a better when the dollar is falling. So, there are levels of this diversification and I don't think that you're diversified if you just own large multinational US companies. Sure, they're getting some of their sales from overseas, but that doesn't tell the whole story about diversifying. I don't think.

Tim: Yeah. I think that ties in nicely with the post that Ben Carlson wrote a few days ago. It was about which investments benefit from a weaker dollar. And he was looking how, recently, since the end of March, the US dollar has been down about 10%. We had talked last week or the week before I think about the dollar being down and where it's coming from and what that means for your portfolio. And you weren't here on that podcast, Brendan, but a note that you had put into

our Slack channel about the podcast was that you want to have a portfolio constructed in mind that will do well in rising and falling dollar environments.

Brendan: Right. It's like anything else, if you think you're going to be able to know in advance how to position your portfolio based on the direction of currencies over six to 12 month periods of time, good luck with that. I don't think you're to have much success. So, short of having that information, how should you put together a mix to account for the fact that over a decade you're going to have several different regimes of rising falling dollar and dealing with the usual ramifications of that. Although, I'll say, these things don't always work perfectly either because we've had years in just the past several where we've had a falling dollar and not gotten what you would've expected from that in terms of the asset classes performing how they usually do, or the reverse, a rising dollar, but we still had something like international doing well when most people would say, "It's not going to." So, these are tendencies, they're not things that you write concretely. You don't know.

Tom: And it's easier to spot in the rear view mirror.

Brendan: Sure.

Tom: It's impossible to say, looking at the US dollar now, and we talked about this in the podcast. Yeah, it looks like the dollar's down a lot this year, but it had a huge spike in March and April, and now it gave all of that back and a little more. If you were to basically erase that big jump that had happened in the spring, it's at the bottom of the band that it's been stuck in. Is this something that's really going to continue to go further? We don't know. We don't really know. So you need to have exposure to all of these areas. I think that's really the message.

Brendan: Yeah. I think just thinking back to a year like 2017, we had a falling dollar for most of the year and international outperformed US that year in terms of stocks. And by the time people were talking about it, it was like the Fall of 17 and you missed the move.

Tom: It was over.

Brendan: And if you repositioned at that point, then it didn't work because, for quarter two, after that, the trend reversed.

Tom: Yeah. Same thing in 2003, four, and even into 2005, we saw dollar weakness. International stocks did absolutely great, but by the time people woke up to it, the move had already been made. Good topics to cover. If you've got questions about any of the topics that we've touched on today, get in touch with us, but that's going to wrap up episode 320. Thanks again for tuning in.