How Should You Diversify From Stocks? - Transcript

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Tom Mullooly: Welcome back to the podcast. This is episode number 322. I'm Tom Mullooly, and joining me today is Brendan Mullooly and Tim Mullooly.

Tim Mullooly: So, this morning, the Fed, Jerome Powell came out and made some comments about changes in their perspective and goals and how they're going to go about approaching inflation and interest rates. What are your thoughts on what he had to say?

Brendan M: I think that this was just him saying something that everybody thought he was going to do anyway, without actually saying it, which is that they're going to ignore higher inflation for the time being, and not pigeonhole themselves so much to a set 2% target for inflation, but rather something that averages out over the long-term, gives them a little more opportunity to say, "We don't need to raise rates so we can keep them lower for a longer time, even if the economy is showing signs of inflation." And I don't know what that means. I don't know if it's good or bad, and I don't think anybody else does either.

Tom Mullooly: In 2012, Janet Yellen stepped up to chair the Fed, and she started talking about this 2% inflation. I actually, I think it was Bernanke who started it and she continued it. They talked about having a target rate of 2% for inflation, and immediately every time that they would have a press conference and it wasn't every meeting at that point, it was, "Well, what do you mean by 2%? Is it going to be one and a half percent, 2%, two and a half percent? Is it going to be an average? What?" And I think this is Powell just saying, it's going to be an average of 2% inflation, but in order for that to happen, if you've got one and a half percent inflation now, you have to get something more than 2% to average 2%.

Brendan M: Yeah, in the past, they would talk about the Fed and their dual mandate being like stable prices, meaning inflation and low, steady, as low as possible unemployment. The natural rate of employment they always talk about. So in the past, maybe people are guessing that they would take a sign and say, "Hey, unemployment is very low. Things are going well in other areas of the economy. We expect there to be inflation. Therefore we're going to raise interest rates because we don't want to be blindsided by inflation." I think this is saying that they're going to let inflation go and they may have to quickly raise rates in the future to catch up to that because I think there's going to be a lot of discussion now about what kind of inflation we're looking at, because you can always point to different areas of the economy and say, "There's definitely inflation there, or there's not here." And it just depends on how the Fed's interpreting that. And I mean, there's no clear definition of that and I don't think there will be.

Tim Mullooly: It just seems like the move has been to preemptively do things because you expect inflation to come from, like you said, low unemployment, but they have said that that hasn't been the case, that the expected inflation never really came, whether or not that was because they preemptively made moves with interest rates. But now it seems they're just going to react, as opposed to preemptively doing things. Once the inflation actually shows up, if it does, then they're going to make moves based off of that.

Tom Mullooly: You're right. Yellen started raising rates in 2014, actually started, I think it was 2015. Her statement at the time was, "As the employment picture continues to improve, we expect that we will get inflation." So they were relying on a forecast of increased inflation, and that's why they wanted, like you said, to be proactive. But for 30 years plus, I've heard people complain that the Fed is behind the curve, meaning they're always too late. We get inflation, then they raise rates. I think what Powell's statement today is he is saying, "We'd be long behind the curve. That's our place. We need to wait. Instead of saying, we are forecasting higher inflation as we get lower unemployment, that hasn't really worked. So now we're putting ourselves back behind the curve. We're going to have a little bit of inflation. Live with it. We can certainly absorb it."

Brendan M: I think if it's a little bit of inflation, that's fine. If there's a lot, I think it may be problematic, but we've only really had that in one instance in history, where financial data is relevant in terms of quick and high inflation happening all at once. I don't know if it's going to be a problem, but I think there could be a potential scenario where it isn't a great thing.

Tom Mullooly: We haven't had inflation, like you just said, we haven't had inflation in such a long time.

Tim Mullooly: High inflation.

Tom Mullooly: I don't think anybody really knows. In 1989, nobody was complaining about inflation. The inflation rate that year was 5%. The market was just fine. So I think one of the big takeaways from me in reading the story today about Powell's announcement at Jackson Hole was that the Fed has really become a better learning machine. We've talked about this on previous podcasts, where they get a little faster and a little more adept at making changes and responding to things. I mean, look at what the Fed did. I know I sound like a broken record, but look at what the Fed did in March and April, how they brought a lot of firepower to help shorten the draw down in the economy. It's really been remarkable, compared to previous disasters when they had to step in. So the Fed is learning and learning to adapt. And that's great.

Tim Mullooly: So, there was an article in the Institutional Investor. The gentleman who wrote the article was claiming that investors, the title was that they're clinging to an outdated strategy at the worst possible time, talking about hedging in your portfolio against stock market risk. And he's talking about how, since bonds are yielding very low interest rates right now that it's not exactly the best diversification method for people. What do you guys think about that?

Brendan M: Yeah. He called the 60-40 portfolio the worst of all worlds, which I think is a little bit alarmist. People are talking about this because bonds usually give you two things in a portfolio, meaning that you would collect an interest rate to hold them. So, you earn something from them while also diversifying your stock risk. Now you're not really getting much from the bond side of your portfolio, assuming you're using quality bonds or treasuries. Absent that, is it still worth it to use them as a diversifier?

I've heard this claim a lot of times in the last eight years, because rates haven't necessarily been much better than they are now at any point in time. They were higher, but they weren't anything to write home about ever over the last decade. And this guy, the claim that he makes is they're less likely to provide protection than they were in the past. My counter to that is let's see, because people have been saying that for 10 years now, and every time the market goes down, high quality bonds and treasuries have diversified stock risks pretty well, in my opinion. Not perfect, but pretty well, like earlier this year.

Tom Mullooly: Yeah. I agree. The quote that caught my eye from that article was he said, "60-40 is an artifact from another time." I agree with you. And my follow-up to anyone who wants to plant a flag on something like this is, okay, diversify with what? With what else?

Brendan M: Yeah, what is the alternative here?

Tom Mullooly: Right. What are you going to offer that's going to provide liquidity like a bond portfolio?

Brendan M: You could hold money in cash. However, I would say that bonds, even with the low interest rates they have, may be better than ... They're not maybe. They're going to be better than cash because you're at least getting something on your money. So if you're going to look at real returns, you're not going to get very good real returns on either bonds or cash, but you're getting a better real return on bonds because at least you're being paid an interest rate for that. So I don't think cash is a solution here.

Tom Mullooly: I also wonder if articles like this or statements like this, just appeal to the people who are just reading the headlines, not really understanding what we're talking about. We get into conversations sometimes and we talk to folks and we recommend bonds. And they're like, "But rates are so low. We'll never make money doing that." But yet with rates as low as they are now, when prices move in the right direction, you can make money even with rates this low. You can see some appreciation in your portfolio.

Brendan M: I'd also add that the reason we're usually discussing bonds as a piece of the portfolio with somebody is because they've also said to us that they can't handle being 100% in stocks. So, you can't on one hand complain about low rates and then on the other one say that you can't be 100% stocks because ...

Tim Mullooly: Well, which one do you want?

Brendan M: Exactly, yeah. One or the other, right.

Tim Mullooly: I think a lot of these articles people have been writing about, you can't make money in bonds when they're yielding nothing. And it always comes back to the question that we have brought up a bunch of times. It's like, well, why are you owning the bonds in your portfolio? If you're owning them to make money, maybe you should just have them invested in equities instead because the odds of you making more money in equities are higher than they would be if you're in bonds. So reading this article, that was the question. That was the thing that just kept coming up in my head was like, well, why are these people owning bonds in the first place? And I think the author was speaking more about pension funds and bigger funds, not necessarily individual investors, but the message for individual investors is different than it would be for a pension fund slightly.

Brendan M: I don't think it is. I think the pension funds like to think that they're these sophisticated people, and I think that this guy was talking his own book because his solution here was to own put options instead of bonds as the way to hedge your portfolio. To which I say fine. But this guy included a nice, pretty chart about how bonds were a drag on returns and use that as some of the ammo to say why they were no longer a valid piece of the portfolio at this point.

But my rebuttal to that is that, of course they're a drag on returns. You're basically viewing them an insurance policy, and that's exactly what a put option is too. He didn't run a chart showing the drag paying for put options over a 10 year period would have had, but it would have been a cost nonetheless. And it probably would have cost more than bonds over the last 10 years, because again, like I said before, you at least got something for owning the bonds and we can round it down to nothing because interest rates are very low, but it's something. Puts are just a cost. It's like paying an insurance premium. So it's not that that's not a valid way to hedge your portfolio. If you want to do it that way, fine, but I don't know that it's necessarily an improvement over bonds. It's just different.

Tim Mullooly: Yeah. I think that's also a difference for pension funds and individual investors. There is more strategy or sophistication, that you need to be able to understand put options or options trading in general. And I feel like the odds of individual investors being able to successfully do that is low.

Brendan M: I don't think it's necessary either. I think it's something that a pension guy would talk about because it sounds smarter than just owning bonds because that's the conventional way or taking less risk owning bonds. Those are the boring average Joe ways to hedge your portfolio. And I happen to think they work just fine. But you can complicate it if you want to by owning options or putting it into some kind of tail risk fund that owns options for you. And I think they're going to ultimately cost you money over time, but if you feel smarter doing it, then congrats.

Tim Mullooly: So, there was a good article from Christine Benz in Morningstar, we bring up her stuff a lot. This was a retirement readiness checklist. She started off by saying that the overall question of am I ready to retire is such a big question. I mean, it's hard to answer that right off the bat. So she talked about how growing up, her mother used to make checklists for things, and it breaks down a big question or a big task into more bite sized, manageable pieces. And then she broke down a couple smaller questions you could ask yourself to see if you're ready for retirement. So we can go over a couple of those, and if you're listening, ask yourself these questions if you're getting ready for retirement.

The first one that she brought up was to consider the retirement date, which seems pretty basic, but there's a lot that goes into that. Obvious financial benefits to delaying a couple of years. If you continue working, you bring in more money. If you have investments, you can let them continue to grow for a few years. But she also mentioned how there are nonfinancial factors that play into that as well. Like if you delay too long, your quality of life, your health, what you can do in retirement might be sacrificed. So there are things to consider when determining when exactly you want to retire.

Tom Mullooly: One of the things that I wrote about just yesterday on the blog was, when you start looking at social security and you look at your actual numbers, if you set up your own account on the social security website, you can actually see what your earnings history was for each year that you worked. And something that a lot of folks overlook is social security will use the highest 35 years of income. So if you start working at age 20 and you have $1000 of income for that year, and you want to retire in your 50s, that may still be one of the years that's included. So if you can work a few more years in your 50s and 60s, that may cancel out some of the earlier years where you weren't making so much money and that can help to actually increase your base.

Brendan M: Yeah, yeah. It could even be part time work because you could be replacing years from when you were 17 years old doing a summer job in high school. You could be replacing an income from that year with, even if it's half of what you earned as a full time employee, that debt could still help raise your benefit for social security eventually.

Tim Mullooly: Yeah. She did say to approach this with some sort of humility, because she did point out that a lot of people tend to be pretty bad at estimating when they think they're going to be able to retire, meaning that people tend to be more optimistic about when they can retire without actually digging into the numbers, like we were just talking about, and figuring out, okay, when is it practical for me to retire?

Tom Mullooly: It's actually a good thing to start doing in your 40s and certainly when you turn 50 is to look at these things. People look at their monthly expenses and they are doing their best to try and project what their monthly expenses are going to be in retirement. But a lot of times, we'll sit at the table discussing with clients things like what your monthly expenses might be with a few more years of inflation on top of it, but then add in a trip or two trips or add in a new car. I mean, a new car today, the average sticker price is like 40 grand. So that's a big expense that most people overlook when they're starting to project how much they're going to need in retirement.

Tim Mullooly: That was the next point that she brought up was assessing your retirement income needs, and how generally the rule of thumb people like to use is 80% of your working income. But she also pointed out, and I agree, not to just simply rely on rules of thumb. They're good starting points, but it's going to be a little bit different for everyone. If you have more in savings, you might not need as much compared to your working income, and same thing with the withdrawal rate of 4% a year from your retirement accounts. They're good starting points, but you actually need to sit down and do it yourself.

Brendan M: Yeah. I think the 20% number, I'd have to look, but my guess is that, or the 80% number, meaning like lop 20% off of your expenses, comes from the idea that people try to save 20% of their income because you obviously don't need to continue saving when you're in retirement. But the way that we'd like to arrive at that with clients is to tally up all the expenses as they exist now. And then, yeah, you're going to back out the savings, but if you were only saving 5% of your income towards the end of your career or whatever, maybe you were saving 30 because you were supercharging your stuff down the home stretch for retirement. It might be a lot different than ... You can't just assume you need whatever your gross income was before retirement.

Tom Mullooly: And one of the trips in that process is, if you're saving 20% of your income, that means you're paying tax. That money comes out on a pre-tax basis. That means you're still paying your income taxes based on the net number after you make your 401(k) or your retirement plan contribution. So your taxes may or may not change in retirement.

Brendan M: Yeah. Depending on pre or post tax savings what you're doing, yeah.

Tom Mullooly: Yeah. It's a big issue. There's a lot of factors that come into play when you're getting ready to retire. The math changes entirely.

Tim Mullooly: So, once you determine how much you're going to need in retirement in terms of income and determine when you're going to retire, that helps you determine how much you're going to need from your investments. And one of the other points, checklist items that she had was to craft a long-term portfolio based off of those income needs. It kind of goes back to how much exposure do you need in the market? Do you need to be taking more risk with your investments or can you afford to have more money in cash and bonds? But the long-term nature of this portfolio that you're still going to have some money invested throughout your retirement to help supplement other things like social security and just traditional savings.

Tom Mullooly: There's so much that comes into play when we start talking about things like that. Folks who sometimes don't even really understand the concept of the 4% rule will bring up the 4% and they think they're taking 4% out every year. That's not how the 4% rule works. I mean, there's so many ... We could probably do a podcast on every one of these topics. So there's a lot to digest with this.

Brendan M: Yeah. So one thing too, these things all get pushed together at this point in time, because once you have a date in mind and the amount you need, then you consider, all right, what am I going to get from social security or a pension? And you've got to fill the gap with your investments, but that may or may not be feasible, or you may or may not be comfortable with the type of portfolio that you require based on the numbers. So another thing suggested was to consider annuities, meaning a single premium immediate annuity. Like can you buy yourself more pension income essentially is what you're thinking about. What are your resources? Would you be liquid enough outside of that still, if you took a chunk of money to buy another income stream on top of your social security? And would that make you feel better about the amount of risk you need to take in your portfolio?

I mean, all these things, you need to consider them. And taxes on top of that too, because you can't just consider your portfolio withdrawals in a vacuum because most times we're talking about 401(k), IRA dollars with folks, and you've got to take more than you actually need to account for taxes. What are your taxes going to look like in retirement too?

Tim Mullooly: Yeah, that was another point on the checklist was tax management, making sure that you're taking money from the right places in the right order, so you don't have to end up paying more in taxes if you don't have to. All of those things play into if you're set up to retire or not. The last couple of things were assessing your insurance coverage. Maybe once you retire, there are certain insurance policies that you have that you may not necessarily need anymore.

And then also make sure your estate plan is lined up and looking the way that you want it to, because by the time you retire, you most likely have a handful of assets that you would pass along to other people.

Brendan M: It's probably the highest net worth you're ever going to have is at the beginning of retirement, because you're going to start living on those assets in some capacity, as you move through the years. So yeah, I mean, if you've got the most you're going to have, then account for it all, and you'd hope that along the way that just continues to work out as you use those assets to live your life.

Tom Mullooly: And just a reminder, not everybody pays estate taxes, but everybody needs an estate plan. It's overlooked by a lot of people.

Tim Mullooly: Yeah. So that was a really good post by Christine. We'll link to it in the show notes so that you can go through all of her points in detail and ask yourself those questions and figure it out if you're getting towards retirement, if you're as ready as you thought you might've been.

That's all we have for episode 322 of the Mullooly Asset podcast. Thanks for tuning in. And we'll talk to you next week.