Why Diversification Works - Transcript

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Tim M: Welcome back to the Mullooly Asset Management podcast. This is episode number 323. Tim Mullooly here today with you, and Brendan is in the room as well. Brendan how's it going?

Brendan: Good, ramping up for a long weekend.

Tim M: It doesn't feel like the end of summer, but I guess.

Brendan: Not officially. That's what, not for a couple of weeks. But Labor Day is the unofficial end of summer.

Tim M: Unofficial end of summer. Part of me still feels like it's somehow March 31st, but the other part of me is like ready for fall. Football starts next weekend. The NFL, hopefully that goes smoothly. It feels odd to think that it's right around the corner like that.

Brendan: Yeah, going to be weird having some of these stadiums without crowds, at least for some time being. But it should be cool, and yeah, I hope everything goes smoothly. What a weird year.

Tim M: Absolutely. Before, we had a couple of articles that we wanted to talk about today, but before we dive into those, we want to address what's been going on in the market the last couple days. We're recording this on Friday morning. So the market is down again today. The NASDAQ is down more than the other indexes. Technology was hit pretty hard yesterday as well. The Dow and the S&P across the board was down a lot yesterday as well. So Brendan, what are your thoughts or your takeaways from what's happening over the last couple of days, to technology in particular, and just the market in general?

Brendan: I don't think two days makes a trend or anything, but just a microcosm of why we have exposure to different areas of the market. Probably seems like these last couple of months here, especially, it's like, why don't we just go all-in on technology and-

Tim M: Why are we owning anything other than Apple, Amazon, Google, Facebook, those big tech stocks?

Brendan: So it seems obvious, and people have come up with reasons for why these companies, tech and cloud computing and all these other companies that fit that mold, have been doing well. Coming up with them after the fact, well, people are at home and their technology isn't as disrupted as brick and mortar, traditional businesses maybe, and other industries. So come up with these reasons after the fact, and certainly performance. The narrative always follows price. So these names have been doing really well for a number of months now, but then the last couple of days have been hit harder than most areas. So you just don't want to be too overloaded or have all your eggs in one basket there.

Tim M: I think the narrative that people have been making up in their head about why these technology stocks have been doing so well, I think there is a large degree of truth to that, but that doesn't necessarily mean that they're immune to ever going down in price-

Brendan: Or that they're going to be leadership forever.

Tim M: Right. So I think looking at the market over the last couple months, coming off the bottom in March, these technology stocks really did lead the way and carry the torch. As we know, with stocks in general throughout market history, they go up and they go down. I think people forget. You get so laser-focused on what's happening in the short-term that you forget that stocks can go down, and they're going to go back up eventually. Or that ebbs and flows.

Brendan: Or that you shouldn't be all-in on what's working right now "working", because we put together portfolios that have exposure to different areas. At certain times you're going to be super happy, like portions of our portfolio that we're exposed to technology growth segments for the last couple months. That seems great. In the last two days, it seems not so great. So you balance that with things like small caps and mid-caps, which have lagged, international stocks, everything has lagged US large cap growth in general, but to varying degrees. So we know these things are going to help our portfolios over time. We just don't know when. So we maintain an allocation to them because we know in the long run, we're going to be glad that we had them, and they're probably going to take different paths to having solid returns over the long-term, which is what makes them good partners in a portfolio with other areas, because they're not always going to do the same thing.

Tim M: Yep. Like if you were 100% in technology stocks, the last couple of days, you're down a lot more than someone who has exposure to all the different areas of the market as well. I also think it's always interesting to watch investor behavior shift back from fear to greed, to back to fear, and how quickly that that can happen. If you think back to February and March, that was less than pretty much six months ago right now. Everyone thought the world was going to end. There was a lot of fear in the market, and it was interesting to see how quickly people shifted back to the greed mentality, and let's go all-in on these stocks, and why aren't we making more? Let's just pile into what's working right now. Now, in the matter of two days, they've already kind of back-tracked off of that.

Brendan: Yeah, we went all the way to the other end of the spectrum, and it's easy to rewrite history in our heads, but it was far from obvious in February and March that we should be backing up the truck to buy any stocks at all, let alone the specific names that have led the way off the bottom. It's only now in hindsight, in these last couple months, month or two, that it's obvious out the rear view mirror that, yeah, we should have been buying technology stocks at the bottom in March. But nobody wanted to do that then. The conversations we were having at that point were largely focused on the bond allocation of clients' portfolios and how it was doing its job, and it was there if clients needed to access any capital while the markets were down. So we were talking about totally different things then. There were not many clients who were calling in looking to ramp up on high-growth tech stocks at the time.

So yeah, messy last couple of days, especially for the leadership of the market of late, but ultimately I think our portfolios here are built with the idea in mind that we have exposure to different areas because we anticipate stuff like this going on from time to time.

Tim M: Ben Carlson, I think, wrote a really good article. He highlighted the story about the McDonald brothers who started the franchise, McDonald's. The headline of the article was How Much Money Is Enough? I think that that is ultimately in my mind, the most important question that someone can answer when it comes to their own personal finances. But I also think that it's probably the most, one of the most difficult questions for people to answer. What were your takeaways from that post?

Brendan: That question, it's kind of like the genesis of financial planning, at least one angle of approaching it. Because there's the mathematical way to approach that of, and clients who are listening have gone through this process with us of just taking a look at what you need to live your life right now, which assumes that you're comfortable and that you're doing everything that you enjoy, and then using those numbers to back into what you have and if it's enough to continue living your lifestyle. Some folks are detailed people and they want to dive into the mathematics behind that with us, which we're happy to do. Some people are more high-level in the sense that they'd like us to do the math for them and then report back to say, yes, you have enough. But you can answer that question from financial planning, at least when you flip that switch from being employed to being retired and living off of your money. But there's just a whole other level to that too in terms of enough. I think one of the quotes in there was just that the answer to that question of how much is enough is likely more, no matter how much you have.

Tim M: Right, because I was just thinking, if you go through that financial planning process and you think, okay, well we've determined that this set amount, X amount, is enough. So once I get to that amount we have enough. But I feel like a lot of people might get to that amount and then it might not feel like enough. You know what I mean? You just constantly want more. It goes back to what we were just talking about with fear and greed. It's like, well, now that I've reached that point that we were trying to get to, I want more.

Brendan: I think it's actually a combination of fear and greed, even though we sometimes place them at opposite spectrum, because I think the enough question is being afraid that you're not going to have the resources that you and your family need.

Tim M: Maybe what I thought was enough isn't actually going to be enough. Maybe I should keep getting more just in case it's not enough.

Brendan: Yeah, I think those two are intertwined there. I don't necessarily think that it's one or the other, even at that point. So it's a lot to wrap your head around, and I think if you don't consider your comfortability and the resources you have, I think you could be in for a lifetime of never feeling like there's enough, despite all quantifiable signs pointing towards the fact that there is at some point.

Tim M: The story that he talked about in there with the two brothers who started McDonald's, I think, was it was pretty telling. It was a success story, I guess, in the sense that they were able to figure out what was enough for them and not really worry about how much money they actually left on the table, because he said in 1960, they essentially were bought out from the McDonald's franchise organization before it really took off and started expanding. They got, it was a million dollars each, which back in 1960 was a very substantial amount of money. But if you, in hindsight, you look back at how much they potentially left on the table, but-

Brendan: They could have had multiples of that.

Tim M: Yeah, but it didn't matter to them.

Brendan: If they lived out the rest of their lives and were happy and enjoyed life with their family, what does it matter?

Tim M: Exactly.

Brendan: So it's a hindsight thing.

Tim M: Yeah, ideally that's the point that everyone should try and get to, but easier said than done. I think it's a tough question to answer. There was an article in Morningstar and there was contributions from a handful of different people that work there. The topic was your number one money lesson. There were a handful, and we'll link to them in the show notes, so you can check out all of them, but I think we each picked out a couple that really stood out in our minds.

Brendan: One I liked from David Blanchett was just that good investing is boring. I think that goes back to what we started the show with, because especially in the last month or two, and you're just hearing about all these people day trading tech stocks like it's 1999 all over again, and that's certainly not boring. It sounds fun, and I think that's why a lot of people do it. But it's only fun when it's going well and it's not going to go well forever.

Yeah, it's unfortunate that good investing is like getting people to eat their vegetables. I wish that it were sexier, more fun sometimes, because it would probably be easier to get folks interested in it. But successful long-term investing, it's not a game. You shouldn't be having a blast doing it. It's something that you should just look to be responsible about. I think it'll be fun in hindsight, but it'll be fun like 30 years from now when you can say, wow, I did all that boring stuff for 20, 30 years and look where I am now. Hopefully then you can have fun with the fruits of your labor, so to speak.

Tim M: Once you have enough.

Brendan: But the act of doing the investing itself, kind of boring sometimes.

Tim M: Yep, and I think that for those listening, if you watch the episode of the Mullooly Asset Show that we did this week, that was the message that I had as well. We were talking about day trading and a lot of the difficulties that come along with day trading and the stress involved, and ultimately the message was exactly what you just said. It shouldn't be high-octane, high-flying fun every day. In the market it's pretty boring.

One that I picked out that I liked was from Holly Black. Her lesson was don't just copy the experts. I think if you watch enough CNBC or you watch Jim Cramer picking out his stocks on CNBC every day-

Brendan: Or Portnoy on Barstool.

Tim M: Yeah, right. Just listening to the experts, I think you need to keep in mind what they're talking about.

Brendan: They may not even necessarily be doing what they're talking about.

Tim M: Exactly.

Brendan: But they give off the vibe that they are when they're on television.

Tim M: Right. The people talking up these stocks might not necessarily own the stocks that they're talking about.

Brendan: Or they could be pumping them in the opposite direction telling you to buy so they can unload-

Tim M: They can sell them at higher prices. So you need to think about the motives behind them. Also, I think not just the talking heads on TV, but also the investing lifetime guru people as well. We've talked about why trying to emulate Warren Buffett's Every move is not necessarily going to be the right move for you. I think if you're going to learn from those guys, you should learn on a high-level and try and take away what's the big lesson here, not necessarily what exact company did he just purchase and I'm going to go buy that?

Brendan: Totally agree. You should be looking for those evergreen-type lessons. From Buffet, for instance, you should take away that being patient with your investments makes a lot of sense in general, not necessarily oh, he just bought this thing. Let me go buy it too.

Tim M: Yeah, exactly. It just goes back to the personal part about personal finance. What works for Warren Buffet or for Jim Cramer, whoever is talking on TV, or whoever you're reading about, it worked for them. It doesn't necessarily mean it's going to work for you.

Brendan: Or that you have to do it that way to be successful.

Tim M: Yeah, you don't need to follow exactly what they're doing to a T. You can take lessons that apply to you and use it in your own life. But I think just trying to emulate and copy exactly what an expert is doing, thinking that's going to work well for you, the odds are it's not really going to work out the way you think it's going to.

Brendan: Unsurprisingly, one of my other favorites was from Christine Benz.

Tim M: I had to earmark that one as well.

Brendan: She just said the idea being that we're too receptive to the notion of reaching our goals without sacrifice. She has this example of a friend of hers who met with an advisor who said, I think you need more small caps and you should look at buying this annuity. Christine was like, I reviewed their situation, and I think they should just save more and probably set up an emergency fund-

Tim M: And spend less.

Brendan: Yeah. So I think, again, the idea that sometimes good investing is boring, like the other favorite from this article that I had, because it's a lot easier for people in our line of work to say, oh yeah, you need more small caps, than it is to work through a cashflow and come up with a way that you can realistically save more. But over the long-haul that increased savings rate is probably going to do a lot more for you than taking your small cap allocation from 10% to 20% or something like that. I don't think that that's going to solve financial problems for people for the most part. Unless their investments are just an absolute train wreck, I think you should probably focus on other areas.

Tim M: She called it getting rich slow. It's the same thing as investing being boring over the long-term. You can't invest your way out of other bad financial habits.

Brendan: Yeah, bad personal finances are not going to be fixed by good investing, I don't think.

Tim M: Yep.

Brendan: I have yet to see it. You can definitely do the other. You can invest sub-optimally. For instance, you could have your money in very expensive mutual funds, which I would not recommend. Our clients know that we prefer ETFs, lower cost options like that. But somebody who saves 30% of their income into high-cost mutual funds is probably going to end up with more money at retirement than somebody who invests in a super low-cost portfolio, but only saves 5% of their income. You're not going to overcome that just because you use better investment options. It's futile. Even with the drag of increased costs, you're just going to lose so much ground because you're saving less. All else equal.

Tim M: Yep. The last article that we wanted to talk about today is about the payroll tax deferral that went into effect on September 1st. So that was just a couple of days ago. If you haven't read too many details about it, this article in CNBC highlighted five things that we think that you should know about it just from an informational standpoint.

The first being, for me, I think that it's a deferral. It's not forgiveness at this point. That's a key distinction I think that everyone needs to understand, meaning that if you choose to participate in this from September through the end of this year, through the end of 2020, you won't be paying your payroll tax, social security tax. But it will catch up to you in 2021. They'll make up for it and start taking it. You'll essentially be paying double through January through April of next year. So it's just pushing it from -

Brendan: Taking your fourth quarter payroll taxes and making them first quarter 2021 payroll taxes.

Tim M: So it's an effort to put more money in each paycheck to people through the end of this year. But you'll see it come out eventually, I think is the point.

Brendan: Unless Congress decides to flip it into being forgiven, then yeah, it's going to come due at the beginning of next year. This also only applies to people whose biweekly pay falls below $4,000.

Tim M: That's like hard cliff.

Brendan: If you make a dollar more than that, you're not eligible. I think importantly, just because of just how messy some of this might be for employers and employees, because we don't know yet if it will ultimately be forgiven or if it's going to be due come beginning of next year, it's important if you're curious to know about this, it's still just a few days after it was supposed to kick in, talk to HR because your employer may not even be doing this. I would imagine that a lot are just not going to do it because of the logistics of this whole thing.

Tim M: It's just messy.

Brendan: Yeah, exactly.

Tim M: That was one of the points too. It was not all employers will offer this. So first question, if you're curious about this, is to talk to your employer, talk to your HR, and figure out if they're offering it, and then figure out-

Brendan: Am I eligible?

Tim M: Am I eligible? Do I want to participate in this if I am? It's not a mandatory thing.

Brendan: Also, and this may not be on the table for a lot considering the year we've had, but they did bring up, I thought, a valid point that the fourth quarter is typically when a lot of folks will receive a bonus. So if that comes in in a regular check or its own separate check, if you are doing this, but a bonus puts you above the $4,000 biweekly threshold, you may have to pay your payroll taxes on one check or another check because of just the amount coming in. But it's ultimately worth a conversation with HR, whoever handles that for your company, just to see if this is happening and what your options are if you're eligible or not.

Tim M: Yep. That article had some good information. I'll link to that in the show notes as well. Before we wrap up, since the NFL starts next week, me and you are both Jets fans. Let's go on record. Assuming it's a normal season, all games are played, everything goes smoothly, how do you think the Jets do?

Brendan: I want them to be good, but it's been like a decade, so I'm very, very cynical at this point. I think they go 6-10 and Adam Gase gets fired.

Tim M: I would be okay with Adam Gase getting fired. I think the Jets will go 9-7, and they'll do just well enough for Adam Gase to hang on and ruin Sam Darnold's career. We're great Jets fans here, clearly not cynical at all. That's going to wrap up episode 323 of the Mullooly Asset Podcast. Thanks for tuning in. We'll see you next week.