Volatility is a Feature, Not a Bug - Transcript

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Tom Mullooly: Okay. Welcome back to the podcast. This is episode number 327 of the Mullooly Asset Management podcast. Welcome aboard. Happy to be back after a couple of weeks. And I'm sitting here with Brendan Mullooly and Tim Mullooly. Hey guys.
I think we should start with the one that nearly half of investors sold in March.

Tim Mullooly: Yeah, there was an article from Think Advisor. They just got some new survey results. The survey was done by MagnifyMoney. And we'll link to it in the show notes if you want to look at all the statistics that they brought up. Like the headline says, it was talking about how almost half of investors out there sold their stock, or at least a stock, or a holding, or they sold something during March during the draw down. And now, most of the people that sold say that they regret it. What's your takeaway from that headline, at least?

Tom Mullooly: Two things from that. They cited that the primary reason given for this answer was people wanted to have cash on hand in the event of a recession. Holy cow, how many videos and how many podcasts have we done telling people that they should have an emergency fund set up, not tied to the stock market, not invested. It should be somewhere safe. Because the moment you're going to need it is when you have to sell everything at 65 cents on the dollar, like a lot of people probably did.

So that was the first thing. The second thing was another point that they mentioned, a clear pattern from the survey was that people have been checking their accounts far more frequently now in the last six months than ever before.

Tim Mullooly: I mean, up until that point, up until the market went down in February and March, we hadn't seen a drop like that in such a long time so people might've been lulled to sleep by the good performance in the market, and then they get shocked by what happened. So then it kind of leaves a scar mentally for them and they don't want to get burned again, or they want to make sure that the trade that they placed, the stocks that they sold or bought during that time are doing well. So, while I don't think it's a good thing that people are checking their accounts more often. I mean, over the last couple of months, you can't help but say like that makes sense to me, at least.

Brendan M: I don't know, there's nothing scientific to this but I think I've heard people talk in the past about how after you sell an investment, people tend to watch it even more closely than when they still owned it, because they don't want to be the idiot who sold and then have the thing go straight back up or bought and have it go down, or vice versa. And so I think maybe people, if they did take action during March, are just paying closer attention, because-

Tim Mullooly: To make sure they made the right decision?

Brendan M: Yeah, and unfortunately, if they sold during March, then they didn't and maybe that leads to them saying that they regret it. But yeah, I mean to Tom's initial point, I think if you don't have money set aside outside of your market investments to have cash ready to go in event of an emergency, that's one strike. And strike two is, if you do have a portfolio and there's any chance that you could be breaking into that, maybe you have an emergency fund, but the second layer of defense would be this portfolio, then it probably shouldn't be 100% in the market either.

And so, the idea that you had to take action in the heat of the moment to change the allocation so that you would be prepared in the event of like a prolonged economic downturn or just a stock market decline, not a good spot to put yourself in and that's preventable. But unfortunately, after a year like 2019 in the stock market, it gets really difficult to sit on cash in a bank account or bonds in a portfolio when the market was up a ton. And now we're seeing it again this year. And so, if you sold during March, don't be the person who then panic buys back in because of performance since then. I mean, there's been ample opportunity for that, but the best indication of future behavior is past behavior. And so, if you freaked out and sold last time, I think the message just is that your allocations out of whack, and that could be for a number of reasons.

Tom Mullooly: Well, old stock guy says, "When you sell a stock, don't look back."

Brendan M: Good luck with that one.

Tom Mullooly: Yeah. Easier said than done. But yeah, it's always hard to look back after you sold something and see it move higher because you do feel a little stupid doing that. But man, oh man, we become emotional gatekeepers, I think, during periods like we had in February, March, and April, where the market was just all over the place and people were losing their minds over this. And so, it's hard when you're panicking, you're checking your account, you're seeing your account going down day by day. It's hard to see the forest for the trees and to say, "I'm going to hit that tree because I'm going 95 miles an hour straight at it." But to kind of step back and say, "Wait a second, wait a second, wait a second. This is for retirement." Or, "This is for a purpose. That I don't need this money right now." It's very hard to keep your cool when the world's on fire.

Tim Mullooly: Yeah. I think it's probably a case of people tying up the wrong dollars. Like you said, if you can step back and say, "This is for retirement." It's easier to not panic, but I feel like a lot of people have money in the market and they have no idea what it's for. They just think, "I should be investing." And there's no real clear cut end game in mind. So when something in the short term happens, yeah, they're more likely to freak out and want to preserve what they have.

Brendan M: I think you also have to understand that what happened earlier this year is what you're signing up for when you put money into the stock market. The risk is literally, always there for a decline of that magnitude. Previously, we hadn't seen one of that velocity before, meaning roughly 30, 35% in six weeks, but it's on the table. And to ignore that or think that it won't happen to you because you're smarter than everybody else or something, is incredibly naive. You need to be prepared for that.

Tom Mullooly: You're right. And we've got quotes here on the bookshelf from Warren Buffet, from Charlie Ellis, from Charlie Munger, all saying the same thing. If you can't stomach the idea of buying something and then next week seeing it down 35, I think Buffet used 50%, you have no business being in the market.

Brendan M: Right. Or you take the investment that has the possibility of doing that and pair it with something that won't do that, and come up with some blended thing where, maybe you can't stomach a 50% draw down so hey, guess what? You shouldn't be 100% stocks, but could you handle 15, 20, 25? All right, let's find a blended portfolio that's going to make that happen for you.

Tom Mullooly: And this kind of leads into the discussions that we're having right now in October of 2020, there's a lot of people who are calling worried about the election results. And we're not taking a stand on either side of this, but my point has been, and maybe you guys feel differently, we got through a 35% draw down from a totally unknown event, a pandemic that hit us. I think we can manage a presidential election. I've been through a lot of these now. And every one of them has been, this could be the election that changes the world.

Tim Mullooly: Yeah, I think, to me, it doesn't really matter why the market goes down 35% in six weeks, whether it's because of a pandemic or if the market goes down because of an election, or the market goes down because of fill in the blank. The reason doesn't matter. It's just whether or not you can sit through it. And going back to what I was saying before about how people potentially got lulled to sleep by the market just continuing to chug along in 2019 and you said it's up over 20%, the same thing surprisingly is happening now. It's just, they have very short-term memory in terms of the market. What happened in 2019, people make the joke nowadays that like, "Oh, stocks can only go up." It's a joke but I think some people actually forgot that stocks can go down, and then they did, and it seems like they've forgotten again. It was six months ago.

Brendan M: And they did in 2018 too. Stocks were down for the year in 2018. In the fourth quarter, we were down over 20%.

Tom Mullooly: Yeah. In one quarter. Right.

Brendan M: So these things are going to happen so you've got to be positioned accordingly. If you have cashflow needs, you need to have money ready to go out and support that when the stock side of the portfolio is taking a crap and you're going to have years like last year in 2019 where the stock side makes up for having a down year in 2018. Right.

Tim Mullooly: Yeah, I mean, I agree with your point that if we can get through something that completely blindsided us like a pandemic, we can definitely get through something like an election where we know the date of when it's going to happen.

Brendan M: I think the problem is, you got to remove the reason for it. As if there's ever one singular reason for everything that occurs. But just look at it in plain terms. If you had a portfolio and you were comfortable or at least not freaked out to the extent that you had to make dramatic changes earlier this year, then yeah, I think that was a pretty good test run, if you want to call it that. Meaning, that's about as volatile a six week stretch as we've ever seen, that was a true bear market draw down. You got to the depths of it. And if you didn't feel the need to panic sell out, then I think you're going to be okay making it through whatever is to come next and for whatever reason. Obviously there are going to be small adjustments along the way, but you just don't want to put yourself in a position where you're learning your true risk tolerance and selling at 65 cents on the dollar as a result. Don't put yourself in that position. So if you had feelings last time, remember them.

Tim Mullooly: Yeah. I think it's important, if you are one of these people that sold and now regret it, don't make that mistake again.

Brendan M: Don't go back to 100% stocks if you were 100% stocks and sold out in February or March. Don't do that because you're going to do it again.

Tom Mullooly: You will. Trivia question. So, market went down in the beginning of the year due to a pandemic. Everybody is freaked out about the upcoming election that could change the world. What was the reason given for the stock market drop in the fourth quarter of 2018?

Brendan M: Yeah, the Fed.

Tom Mullooly: I thought it was China. Like tariffs and trade wars and stuff like that. I mean, that's all we heard that year.

Brendan M: Yeah. The Fed was tightening and we were doing all the tariff nonsense and it wasn't good for anybody so we all freaked out.

Tom Mullooly: And I think it was January third or fourth, J Powell came out and said, "Oh, only kidding about all that tightening."

Brendan M: Yeah. "We're not going to hike anymore."

Tom Mullooly: Yeah. And we were off to the races. Tim, we had another article that we to talk about as well.

Tim Mullooly: Yeah, there was another article from Think Advisor as well. It was talking about some of the advantages of Roth conversions for retired investors, and they highlighted some of the main benefits for doing a Roth conversion. But I thought it would just be a good opportunity to talk about the ins and outs of Roth conversions, the good and the bad, the right time or the wrong time to do it. What do you think are the main benefits to a Roth conversion? And when is the right time for someone to do it?

Tom Mullooly: We've had a couple of conversations with some folks this year who have said, "This might be the year for me to do a Roth conversion because taxes have to go up in the future." I don't necessarily know if that's really the right approach, if that's the right answer. Because if you're realizing a lot of income this year, to do a Roth conversion on top of it, you could very well be pushing yourself into another higher tax bracket. And so, a lot of times, Brendan, you and I talk about doing Roth conversions when someone has only worked for part of the year, or maybe they have lower income this year, for whatever reason.

Brendan M: Yeah. I think it's important to remember that there are multiple moving parts to this. The two most important of which are not only the tax climate as it exists today. And yeah, maybe tax rates are amongst the lowest we'll see for the next several decades. We don't know for sure know, outside of our control, but they're pretty low right now. But outside of that, it's also, what tax bracket are you currently in? How much extra income would put you into another one? And what does your situation project to be like down the road? Outside of a tax brackets, changing, which they could, how much income are you going to have in the future? And may there be better opportunities down the road, even if let's say taxes are higher?

And you can kind of like jump through these exercises by looking where income taxes were before the tax cuts and jobs act in 2017 and say, "All right, well maybe if we were back to there and I had this much income..." You got to try to do apples to apples the best you can, even though it's impossible to, because we don't know what future tax rates will be like.

But in general, I think your best opportunity to do a conversion is maybe a year where you retire and are going to be in a lower tax bracket as a result of just living off of accumulated savings, depending on your situation. Or if you work half of the year, like Tom alluded to, maybe you're going to have half as much income as you normally would, and maybe that's an opportunity to recognize some extra income now while converting to a Roth. And the biggest benefits to that would be tax-free compounding until you decide to take it out in the future and hopefully you let that go for as long as you possibly can.

I think on top of that, I would say that a lot of people have been thinking about it because it's a topic getting thrown out because tax rates are low and one of the candidates for president is talking about potentially raising them on certain people. And so, it's worth exploring, but you read a lot of articles about Roth conversions and their benefits, but really the answer is to get some information from, not only your tax preparer, but then sharing that with your financial advisors so they can say specifically for you, is this a good time to do it? Is there a strategy here where you could do it over a number of years and have it be to your benefit? But you really need to dig into the details and get information from multiple professionals unless, your advisor's both.

Tim Mullooly: Yeah. I was going to say they, they pointed out in the article, how Roth conversions can help potentially improve your retirement income projections if you don't have to account for taking money out of a traditional IRA and paying taxes on that. And just for estate planning purposes as well, the money has already been taxed. So, on top of what you're saying too, that's another reason to run it by your financial planner. I wouldn't just wake up tomorrow and say, "I'm going to do a Roth conversion today."

Brendan M: That's a good point.

Tom Mullooly: Yeah, don't leave this to-

Tim Mullooly: There's more to it.

Tom Mullooly: Yeah, don't leave this to Google to give you the information. This is something that you really need to coordinate between your tax preparer and your financial planner.

Brendan M: And in almost all cases here, you're going to have to be prepared to account for that extra income tax that you're going to owe out of pocket to have it really be beneficial to your financial plan in the long run, at least in my experience, from what I've seen crunching numbers for folks. Whether, that's coming from savings or if it's early in the year, and maybe you're going to jack up your withholding's on your salary, if you're still employed. There are ways to work it out, but the tax money has to come from somewhere and if you're going to withhold it on the distribution, I feel like the long run ramifications of that, you're going to have to let that tax-free money compound for quite a while to make up the difference there.

Tim Mullooly: On top of Roth conversions, being a hot topic this year, potentially changing your domiciles, also another hot topic, I feel like for 2020. And there was an article from worth.com talking about four factors to consider before making your second home your domicile. And this is another thing that you don't want to just wake up the tomorrow morning and say, "I'm going to change my domicile." Mostly because it's not that easy. One of the first things they pointed out in the article was that it's not as easy as just declaring that, "This second home is now my domicile." It's like Michael Scott in The Office, you can't just declare bankruptcy by saying it out loud. There's a little bit more it.

I feel like people, whether they have a primary residence in maybe a city and they have a second house somewhere not in the city, they might've been spending more time at their second home this year thinking, "Maybe I'll flip my domicile to the second home for this year." Not as easy as you might think.

Tom Mullooly: No, it's not.

Brendan M: Yeah. There are a lot of rules that you have to follow to make that official and I think you're opening yourself up to a lot of risk for an audit if you're not actually doing what you're claiming to be doing. So, definitely not recommended there. So it's got to be an actual move of domicile with the corresponding...

Tim Mullooly: And like a pretty permanent move too.

Brendan M: Yeah, I think first and foremost, I don't think you should be making decisions about where to live just based on taxes alone. We talk with investments all the time about not letting taxes dictate your investment decisions. Overall, your portfolio is still needs to be an appropriate portfolio for you and your circumstances, regardless of the tax ramifications. And I think that the same goes for this.

So, if you could pick up today and move to a different place where your tax situation might be different, property or state income tax or whatever the case may be, and you'll be just as happy, then great, totally do it. But I think the important note there was the last thing, that you'll be just as happy. And there's a lot at play when it comes to decisions to just uproot and leave, meaning family and routines and people and things, and all the aspects of your life that you enjoy. And I think taxes are on the list, but they're nowhere near the top of it.

Tom Mullooly: I think that part of the whole tax conversation has to be a fair amount of what I call being reasonable. I'll give you an example. We've got a client who is looking to purchase a home, we're going to need to sell some stocks. He really doesn't want to do it, but there's really no other way around it. And so, I sat down with him and laid out a couple of scenarios and said, "Look, if we go this route, you're going to have to write a check for about $2,500 in capital gains taxes." "Oh, that sounds pretty good." I said, "Going the way that we originally talked about, you're going to be writing a check for about 13 grand in taxes." And he was like, "That's not so bad either." Considering the amount of money that we were raising and he was okay with it.

So, we have this big boogeyman called taxes, but sometimes when you do the math and you look at, "Okay, the long-term capital gains tax rate is 20%. What is that going to mean in dollars and cents for me, if I'm looking to raise money, take money out of the market to do something with it, to buy a house, to do something else?"

I'll also tack on to this conversation that I did get an email from someone who is looking to relocate out of the country. They want to become a citizen of Uruguay. Apparently there's a lot of tax benefits to it. I was afraid to click on the link because I thought it might take me to a weird place.

Tim Mullooly: Kind of to Brendan's point, I hope that if they do that, they enjoy spending time in Uruguay and not just for the tax benefits.

Brendan M: Yeah, you should live where you want to live and... I mean, obviously, factor the cost of living there, I understand that that is an aspect of it too, but I'm not sure that I would just make a decision like that solely based on the income tax situation or the savings that it'll throw off to you. If you save a bunch of money on tax, but have no friends and family within 200 miles of you, then I mean, if that's the life you want to live, then that's great. But personally, I think there's a little more to it than that and I think a lot of people throw around these ideas and they don't actually mean this stuff because they haven't considered what moving away from a place they might've been their entire life would actually be like.

Tom Mullooly: So, should I share the Chicago story?

Brendan M: Yeah, go ahead.

Tom Mullooly: At the end of 1988, I had a job offer to go work in Chicago. I worked as a broker on Long Island, and so, this was a big move. Uprooting myself and my fiancé, now wife, to move out to Chicago. She quit her job with the intention of looking for a job when we settled down in Chicago. For weeks and weeks and weeks ahead of this move, we did one of these Ben Franklin, pros on one side cons on the other. Here's the pros of moving to Chicago. Here are the cons of moving to Chicago. The one con that was on that side of the ledger was we'll be far away from our family and friends. Well, sometimes stuff just doesn't balance out on a piece of paper.

We didn't realize until we were out in Chicago, how far away our family and friends were. And that one con outweighed all the positives by a factor of 10.

And so you really have to think about what Brendan said. You've got to be happy where you wind up because you're going to be there for a while. And so you really need to think it through. Not just the numbers. So I've been accused of being a numbers guy and a numbers guy only, you have to look at the whole picture. It's really very important.

So it's fun to have conversations with clients who say, "Hey, I'm thinking about getting out of New York and moving to Florida." "Okay, let's talk it through." And so, we help to paint the entire picture so they can see the numbers side, but we also try and talk a little bit about the personal side too. So, it's important. It needs to be part of the equation.

Brendan M: As you said, if you're going to make move, plan on actually being there. So, if the whole idea of a second residence is some kind of tax arbitrage, I would caution that that's a lot more work than you probably think it is.

Tom Mullooly: That should be number 10, 11, or 12 on the importance list. The tax angle.

Tim Mullooly: From a technical standpoint, I mean, you have to prove to the States that you have established a new domicile and you essentially permanently left the old one.

Brendan M: Spent enough number of days-

Tim Mullooly: There are a number of different factors that you have to prove. So it needs to be a relatively permanent thing. Just because you spent a lot of time there in 2020, maybe because of the pandemic, doesn't mean that you can change it for 2020, you get the tax benefits and then flip it back in 2021. Like you said, you mentioned an audit before, they said in the article 2020 audits aren't going to start for another two years. So, that's-

Brendan M: Get ready.

Tim Mullooly: ... going to be pretty tough to prove if you tried to do a quick flip-flop one year.

Tom Mullooly: All right. That's going to wrap up episode 327. Thanks again for tuning in. And we'll talk to you on the next episode.