Watch What They Do, Not What They Say - Transcript

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Tom Mullooly: Welcome back to the podcast. This is episode number 328. Thank you for joining us. I'm Tom Mullooly, and joining me today is Tim Mullooly.

Tim Mullooly: Hi, everybody.

Tom Mullooly: And Brendan Mullooly.

Brendan M: Ready to rock. Let's do it.

Tim Mullooly: There was an article in the Wall Street Journal. We were just discussing it before we turned the microphones on. It was about how the coronavirus tanked the economy, that's the headline, but then credit scores went up. And as you're reading the article, it does make sense why some people, their credit score, the average FICO credit score went up a little bit over the summer months. If you're not going out as much, you're not putting as much on your credit cards, you're tightening your pockets in a sense and not spending as much money. You're not racking up credit card debt, or maybe you're using some money to pay down debt. It got me thinking about if the credit scores going up are a good thing if it's potentially just propped up by temporary stimulus. You know what I mean?

Brendan M: That's what the banks seem to be worried about. It sounds like they're searching for additional measures that they can add to. These credit scores are just a composite basically that's supposed to spit out some number that tells a bank or a lender about your credit worthiness. And it sounds like a lot of them are worried that they need to do some updating to how these numbers are put together because they're not getting the information that they need or that they don't necessarily trust these numbers because they've been improving while we've been getting poor economic data. And it's tough for them to sift through who is worth lending to and who isn't because there-

Tim Mullooly: What's real and what's not.

Brendan M: ... hasn't been any ... You can't tell the difference between somebody who took a pass on paying their mortgage for the last several months just because they could and somebody who actually needed to, just as a one off example.

Tim Mullooly: Yeah. That's what came to mind for me right away was like, well, does this just put into jeopardy the legitimacy of credit scores in general?

Tom Mullooly: I wonder if the authors will go back and rewrite or re-examine this story as we get closer to Christmas and we find that maybe the economy doesn't snap back like some people are predicting, and this additional unemployment insurance, the initial part of it ran out at the end of July. I know that Congress is still talking about a second stimulus, probably a lot smaller than what they did in the first wave. But I just wonder if the credit score as a number, like a black box tool that banks and lenders used to use. I just wonder if it's really effective in this kind of situation. It doesn't seem to be.

Tim Mullooly: And the number that they pulled citing that the average score had increased was from, I think either July or August. So it makes sense from a standpoint of when the stimulus actually happened to what people were doing at the time. So I agree. It'll be interesting to see if they follow up how the scores progress or regress over the next couple of months now that things have run out.

Brendan M: They also noted that it's been a lagging indicator in the past. Meaning that, for example, in 2009, October was when credit scores bottomed, which was well after the end of the market downturn and the recession even. So, recession is different by everybody's measures, but by the textbook ones, at least, that's what they were looking at. I did think that one thing from the article was good, and it was a survey, so take it with a grain of salt. But people seemingly have been using stimulus or relief or whatever they've been receiving to pay down debt. It said 35% of people surveyed said that they used some kind of stimulus to pay down debt, which improves credit scores. It can improve cashflow too. So I mean, that gives me hope that people took a look at this money that was coming in and they were like, "All right. If I've been put in a bad position because of everything going on, what is the best possible ROI I can do?"

We heard all these stories about people throwing their $1,200 stimulus checks into their Robinhood accounts. If somebody had consumer debt, for instance, and they got a $1,200 check and with the unemployment insurance, they could make things work from a cashflow perspective, one of the best things they could do is get rid of that debt that was probably compounding at 15%, 20% just eating away at their net worth. So I mean, if that's what people were doing, then that's awesome. That's great. I'm glad to hear people were being responsible with this money.

Tom Mullooly: Yeah. One of the single best quotes I found in that article right near the end was a woman who was quoted as saying, "COVID forced me to really look at my finances." Hallelujah. That's fantastic because unfortunately it takes a global pandemic for some people to get serious about their money, but-

Brendan M: Hey, whatever it takes.

Tom Mullooly: Right.

Tim Mullooly: As long as they get the wake up call, that's all that matters. They were saying how, you mentioned how lenders are looking for different ways to assess risk for these people if they're questioning the credit scores, and they said using personal cashflow data for individuals to help determine risk. When I read that, I was like, maybe they should or should have been doing that all along. It seems a little more tedious obviously than just looking at a three digit credit score number and determining it based off of that, but if they want to be more spot on with the risk that they're assessing for people, I feel like just taking a look at their cashflow would probably be the best indicator for how ready they are to pay down debt or pay back loans and stuff like that.

Tom Mullooly: I think the big problem with that is, yeah, if you're applying directly to a bank for a mortgage or some kind of direct loan with a bank, then they can take their time and really scrub the numbers. But when you're sitting at the car dealership and you're trying to finance that car that you bought, they want to run that credit score and get you in the car that afternoon. What's it going to take to get you in that car today?
Brendan M: That's not necessarily good for the consumer. It's good for them. So it's convenient for them to not care about the details because their business is predicated upon-

Tim Mullooly: Selling as many cars as they can.

Brendan M: Yeah. You want to buy that car then, so they want to get your impulse before you think better of it and buy something different.

Tom Mullooly: One thing I just thought of as we're talking about this is how would you like to be the guy at the bank who gets that phone call, 10 o'clock Monday morning, "Hey, you bought 37 cars this weekend," because honestly you own the car. You've taken on all this debt. Congratulations.

Brendan M: Yeah. I was going to say, I think it's kind of a rough spot that everybody is in because I can understand from the bank's perspective or lenders, whoever's doing the lending, they want to be more certain than maybe a FICO credit score is giving them on the surface. So they're looking for more details. That's their business. They need to make good loans to be viable. But if they're not going to give folks the financing that they need, or they're going to pull back and make things more difficult in terms of people looking for money, then that's going to only put more stress on the government to then either backstop the lenders and say, "Hey, it's okay to make crappy loans. Don't worry about it," or the government's just going to have to do their own thing, meaning more stimulus. And they go hand-in-hand. So, there's a misalignment there because it seems like nobody wants to give out the money because the government's dragging their feet. And then in the meantime you have all these lenders saying that they don't want to do it either. And that's bad for the entire economy.

Tom Mullooly: It is. Credit dries up at the worst possible time. We just recorded a video talking about October 19th, 1987. And overnight, that was Monday night, the market went down 500 points, 22% in one day. Overnight banks were telling the market makers, these were the guys who used to run around on the floor of the exchange, "We're cutting off your credit." What? These guys are the buyers of last resort. How many people wanted to sell the next day? All of them. And the banks have a history of doing this. Credit dries up at the worst possible time. Sorry to be a show stopper with that.

Brendan M: No, there's no easy answer to this because they're not charities. They're here to make money. So they don't just give out loans for free, but the entire economic system relies upon them giving out loans. So, they need to make the loans too.

Tim Mullooly: Yeah. Yeah. So it'll be interesting to keep an eye on credit scores and what goes on with them over the next couple months to a year, perhaps. There's another article in the Wall Street Journal written by Jason Zweig last week. The title of the article was Look Who's Really Chasing Hot Stocks Like Zoom. And we've been hearing, if you watch CNBC or read any financial media articles about how Robinhood traders and day traders are moving the markets with their stock speculation moves. And Jason pulled the lampshade off that argument in his post writing about how, if you look at it, institutions and professional investors are a big portion of the people out there that are speculating in these hot stocks like Zoom. And he talked about a couple others in the article as well.

Brendan M: Yeah. What I took away from this was just that the pros can't help themselves either, and they're window dressing in their funds to show you that they own the hottest stock from last quarter too, because they don't want to get fired from their job. And they're, even in some cases, it sounds like breaking or at least bending their mandates in terms of what they're supposed to be doing to get into these names. And I wouldn't be very happy if I looked under the hood of an active mutual fund that I thought was for mid cap value stocks to find out that it owns shares of Zoom, even if it's in a small amount of the fund. I think that's a part of the reason why ETF and index products have come to be more prominent over the last few years, because at least you know what you're getting and you don't have some guy or girl who's worried about losing their job each quarter window dressing just for the sake of it. Yeah.

Tom Mullooly: Well, let's just talk for a moment about what window dressing actually is. When a mutual fund manager, an active manager, not someone who's following an index, but when an active fund manager, they have to put out two reports at a minimum, a six month semiannual report and an annual report. But once a quarter, they'll usually release what their holdings are. And they'll tell you, "We own these stocks at the end of the quarter." At the end of the quarter. They never tell you-

Brendan M: Yeah, you don't know when they bought them.

Tom Mullooly: Yeah, they could have bought it yesterday. So as long as you appear to hold all the right names, that could be window dressing, because you may not have held those positions for the entire quarter. You may have just bought them yesterday,

Tim Mullooly: Right. Yeah. And like Brendan was saying, there was a specific example in there of an active value fund that owns Zoom that's currently trading, I think the number was 690 times earnings.

Tom Mullooly: But only 200 times next year's earnings.

Tim Mullooly: Right. But it's supposed to be within, it's under the hood of a value fund, kind of the opposite of what value investing is there. So it's not really what investors, I'm guessing, would expect their value fund to own, but they're essentially just chasing performance. And like you said, they're trying to keep their jobs.

Tom Mullooly: It's hard to look at the David versus Goliath picture and honestly believe that these people are saying with a straight face that it's Robinhood traders and individuals who are driving these prices.

Brendan M: We paint that picture as if it's people on their phone, who are these emotional basket cases who are trading stocks and doing silly things, but we're all humans. So if some of them are behaving that way, because some of them are, I agree, some, that means that some active professional investors who run mutual funds separately managed accounts or hedge funds are doing silly things too, because they're human beings.

Tom Mullooly: Sure.

Brendan M: So temptation spans the spectrum no matter how intelligent or in tune with the professional investing sphere you are. You can be a pro or a total amateur and you still want to own what's hot.

Tom Mullooly: Sure. Yeah.

Brendan M: And not be smart.

Tom Mullooly: But maybe it's just the naive, simplified way that I look at things. I don't care how many individual people go in and buy seven shares of Zoom or even 50 shares of Zoom. That's never going to add up to a guy who's managing a billion dollar fund or a billion dollars in assets who says, "I'm going to put, I don't know, $100,000 or a half a million dollars," a very, very small position for them, into a stock. One click, one trade. It's just never going to add up, where these individuals are going to swamp to an institutional investor. No way, no way. It will never add up.

Tim Mullooly: Some people in the industry and the media have been wagging their finger at the individual investors speculating on these stocks when in reality they're doing the same thing. So just, to me, it speaks to, watch what they do and not necessarily what they say, because they'll scold you for doing it, but behind closed doors, they're doing it the same as what they're telling you not to do so.

Tom Mullooly: You've got that right. Yeah.

Tim Mullooly: That's my take on it.

Brendan M: And I don't think anybody should be doing it. They're chasing performance and doing silly stuff, regardless of who we're talking about. I think it's just easier to say that it's the amateurs doing it than the professionals because we assume that the professionals are smarter than that, but I don't think it's an intelligence question. It's an emotion question. And once you start crossing those wires, I think everybody's on equal footing. It doesn't matter how much experience in the market you have.

Tom Mullooly: The problem I have is what we mentioned early on when talking about this article, is that if you have a professional who's got a mandate to buy value stocks or to buy small cap stocks and he's jerking around with something that doesn't fit what he's supposed to be buying, that guy should be fired. He's not doing his job.

Tim Mullooly: I guess it depends on what doing your job is because if it works, no one's going to care. But if it doesn't work, that's when people would get upset, I think. There was another article in the Wall Street Journal that piggybacked off of that, or they were similar in a sense. They were talking about these individual investors, and the headline read Individual Investing Boom Fuels Trading and Low Priced Stocks. So this was about how the people that are actually trading on Robinhood, a lot of them are buying and selling stocks that are $5 or less. I think the stat was more than 25% of the shares traded in the US over the summer on Robinhood where stocks less than $5. So again, there is a lot of activity going on and accounts being made and trades happening, but I don't think it's necessarily moving the market as much as people on TV or online on Twitter might be saying that they are.

Tom Mullooly: Couple of things come to mind when I see that $5 stock price being discussed. $5 is usually the threshold for whether a stock can be marginable or not. So you're not going to get a lot of people who want to do things on margin hanging around the $4 or $5, $6 price tags, because they're going to run into a situation where tomorrow, if the stock moves against them, they're going to have a margin call right away. That's something. The other thing is that they're usually very thinly traded. So it's very hard for anyone with size, like that billion dollar asset manager I just mentioned, to go in and take a meaningful position in something without basically bidding against himself. The other thing that I'll mention is that a lot of times when you're dealing with low priced stocks, there's a lot of shadiness going on.

Brendan M: Yeah, pump and dump.

Tom Mullooly: Yeah. That's what it is.

Brendan M: Yes, it is.

Tom Mullooly: So, it's a lot of fraud. There's a lot of hijinks going on. We saw a couple of examples of it right in that article. They talked about a few stocks that really had no news, but were going up double and triple their price in a matter of days and then getting sliced in half a week later.

Brendan M: Yeah. Play stupid games, win stupid prizes. I thought the interesting thing, and maybe this is just me inferring something that's not there, but if you looked at that chart from the article that showed the percentage of trading for $5 or cheaper stocks, it seemed like from 2013 to 2019-ish, it was like 10% or 15% of trading pretty consistently. And then around the second half of 2019 through today, it was between 15% and 25%, depending on when you were looking. And that coincides with this move to free trades for all of the platforms, which if you're going to buy even 100 shares of a $5 stock, a commission of five or six bucks is not insignificant in terms of ...

Tom Mullooly: The percentage.

Brendan M: Yeah. So, it enables people to do stuff like this. And I don't think that that was an unintended consequence of all these brokerage firms doing what they did.

Tom Mullooly: Yeah. There was a certain amount of friction with commissions involved. Back in the day when I was a broker, many moons ago, two of the speed bumps were, well, how much is this going to cost me to sell this stock? Well, the commission is going to be $275. I better think about it. And what's the tax implication on something like this? So taxes and commissions were things that stopped people from rapid or frequent trading. Those frictions are, well, the tax thing is still around, but the friction of commission, that's eliminated now. So we're seeing a huge spike.

Brendan M: Yeah. And just a note on the tax thing, I think there are going to be a lot of surprise 1099s for newly established day traders in 2020, so make sure to subtract whatever that is from your net returns, because that's how everybody else plays ball, in case you were wondering.

Tom Mullooly: Yeah. So when you're bragging about all your wins-

Brendan M: After tax, after fee performance is what you eat. So I think there's also an element of trading in these stocks that are $5 or under of just like lottery gambling mentality. Because I think for some people, it just sounds easier for a stock to go from five to six than it does to go from 100 to 120 when in fact it's the same exact move, and it's just as difficult or hard depending. It has no bearing whatsoever that it only has to go from five to six and it's only a dollar because it still has to make up as much ground as the stock that needs to go 20 bucks higher to make 20% starting from 100.

Tom Mullooly: It's the same percentage return.

Brendan M: There's no difference, but it just seems intuitive that it should be easier to get from five to six. So it seems easier mentally to turn these big profits in these cheap stocks. And that's not true.

Tim Mullooly: Yeah. I also think it's easier for people to pull the trigger on buying some of these names because they're only four or five bucks. It takes more out of you to buy more expensive stocks. Like, "Well, this thing's only five bucks. I could swing that." Even if you're putting the same amount of money that you'd put into a $100 stock, if it's a $5 sock, it's like, "Eh, it's a $5 stock. We'll see what happens." But you might have stronger feelings about it if it's a more expensive stock.

Brendan M: It's the same stuff we talk about with stock splits.

Tim Mullooly: Yeah.

Brendan M: Absolutely no bearing whatsoever on future returns. I hope people learned that lesson over the summer too, because they should have.

Tim Mullooly: The last article that we wanted to talk about this week was from CNBC, and it talked about some financial advice for new parents, and they listed some numbers in terms of how much to expect in today's day, raising a child might cost, with college and other things involved.

Tom Mullooly: Having a kid today, according to the article, is a quarter of a million dollar road.

Tim Mullooly: Right. They said in the article, they said for a middle-class couple, they can expect to spend over $230,000 raising a child, and that does not include college, which they then went on to say by 2036, a four-year private college, they estimate would cost about $303,000. So if you put the two of those together, raising your child would cost just slightly over half a million dollars.

Brendan M: It's obviously not due in one lump sum payment when you bring them home from the hospital, but yeah over-

Tim Mullooly: Over the span of 20, 21 years until they get out of college. And then if you have loans maybe like 25 years or so to pay it off. But yeah.

Tom Mullooly: So they said that up through age 17, it was 233,000, which works out to be an average of about 12 or 13 grand a year, or just over $1000 a month. When our family was growing, you start thinking about things like diapers and food and clothing, and you're going to have to get a crib or all these kinds of things. You don't really add all this up and it doesn't all happen in straight lines either.

Brendan M: We don't actually do this for ourselves either though, because if you wanted to do just loose math, if you know what you spend on a monthly basis and say you're not ... Maybe you're married without child right now. So divide those numbers by two on what you're spending per month and that's what you cost. And you can tally that up over 20 years.

Tim Mullooly: That's what it costs to raise you.

Brendan M: I can tabulate my own costs for the next 20 years. I mean, it's good to have a grip on these numbers, but I don't think you should let that psyche you out of doing things because you're obviously finding a way to make it work now, but you've got to be aware of the costs. They were talking about how much it costs, like childcare is insane these days. And a lot of parents are forced into a decision of potentially a two income household becoming one because it doesn't make sense anymore, or it's going to continue to be two incomes, but you're going to have 1000 or 1500 bucks a month lopped off because you need someone to take care of your kid while you guys are working.

Tom Mullooly: Yeah. Big decisions and not to be taken lightly.

Brendan M: There's some interesting math in there too. And it was just basic compounding formula, but they were talking about earning something, I think like a 6% or 7% rate of return on money that you would invest and saving the same amount. So $500 a month was the example. And if you started right away when your child was born, at 18, you'd have almost $200,000 set aside for them. But if you waited until they were 10, you'd only have 60, by the time that they turned 18. So obviously in a perfect world, you can just transition directly into whatever increased expenses you have on the forefront and then also set aside money every single month, and I know that that's not reality for a lot of folks, but to remember that the earlier you start, you're going to have a better advantage.

Tom Mullooly: With everything.

Brendan M: A bigger advantage, I mean. Looking at life insurance too. I mean, when you're starting a new family, you and your spouse, regardless of if you're both working or not, are probably going to need to consider if you have enough coverage because you have a dependent and if you want to have money to not only support the surviving spouse, but also to maybe pay for school or to make sure that your kid's taken care of through when they become an adult. I mean, these are all things you've got to factor in when you're thinking about starting a family.

Tim Mullooly: The catch there that they pointed out for life insurance, if you want to do that, you should make sure you have the right amount in place before you get pregnant or once you decide that you want to try and start having a family, because that changes things when you go to get another policy or get more coverage, if you're pregnant or already have a child.

Tom Mullooly: Right. Yeah. And the longer you wait, the more expensive it's going to get anyway, the older you get. So, all good things to talk about with your planner. That's going to wrap up episode 328. Thanks again for tuning in, and we will catch up with you on the next episode.