Paying Off Debt, Investing Strategies, & the Power of the Internet - Transcript

Tim Mullooly: Welcome back to the podcast, this is episode number 197, this is Tim Mullooly.

Tom Mullooly: Tim Mullooly battling a cold, and Tom Mullooly here, I'm okay.

Tim Mullooly: Yeah, got a little cough and a cold today, but I'm going to do my best to power through. We're going to continue answering these questions that we have from our viewers. We also get them from an anonymous website, people send in their situations. Light on details, nothing specific but just some general questions about personal finance and investing and financial planning.

Tom Mullooly: Really great topics that we get and sometimes we don't answer the question directly, but it kind of gives us a spring board into another topic, or discussion that we do want to cover. So these are really good topics and if you've got a question about financial planning or investing or managing money, get in touch with us and you may wind up seeing your question on a video or used in a future podcast. So you should also know that with all of these different topics that we cover, that none of our comments should be viewed as investment advice or financial planning advice. Specific financial planning advice for you. Every situation is going to be different so please take the time and speak with an investment advisor, financial planner, if you don't have one we'd be happy to help you out as well.

So Tim why don't we jump right into the first question that we've gotten?

Tim Mullooly: Sure thing. The first question today asks "How should I invest and save right out of college?" The summary goes on to say I am 22 years old and landed my first job a couple months ago. I make close to $45,000 a year and I'm currently contributing to a 401k with a company match but I would like to increase my retirement savings even more since I am living at home still and not up to my neck in expenses. I don't have any debts besides student loans, I have a ton of long term goals but I mainly just want financial piece of mind later in life for me and my family. In parentheses, and a nice vacation home smiley face. How do you recommend I save and invest to reach all of my goals later in life? Should I open a Roth IRA or Roth 401k and start contributing to that? How can I maximize my savings?

Tom Mullooly: The overriding question in a lot of these questions that we've gotten over the last few weeks is “how can I maximize my savings?” Like how can I go to McDonald's and super-size my meal? How can I maximize my savings? People feel that they're not being smart by leaving money in a savings account, but yet that may be the smartest thing to do.

Tim Mullooly: For a 22 year old I was a couple years ago myself a 22 year old, living at home and this person is very worried about saving for retirement and getting a vacation home later in life. But my answer to them would be if you're still living at home, why don't you use some of that money that you want to save for retirement and save it for a down payment so you can move out of your parent's house?

Tom Mullooly: In retirement, where are you going to live? You're going to live in a home.

Tom Mullooly: So I agree with Tim, it's great to see that you're contributing to a 401k with a company match. It would be optimal if you're at least contributing what the company will match. After that it's really a personal decision about how much you want to invest for retirement and how much you're going to be setting aside to put as a down payment on a house. That's really important and I didn't see that anywhere in this question.

Tim Mullooly: Right and they also go on to say they don't have any debts besides student loans. And while I'm not saying that you should take all of the money you're making now and pay off your student loans in three months or whatever, but maybe consider upping your student loan payment each month and getting rid of that loan payment quicker. It can never hurt to get out of debt, which we're going to touch on in a later question as well.

Tom Mullooly: Totally agree, I think the first few things that this person with the question should be focusing on is make sure you're contributing to your 401k up to the max that the company will match. If you want to do a little beyond that totally okay, but don't go crazy maxing out your 401k contribution. The second thing is to have a safety net, money in the bank, maybe it's a short term bond fund, maybe it's a CD maybe it's some bank investment that's earning next to nothing. You are maximizing your savings by doing that, by just having it. Having a little bit of cushion to handle a car repair, to handle things that come up. You need to have that, so continue to contribute to the 401k up to the company max and maybe a little beyond.

Number two, work on getting some kind of safety net. I'm amazed at how many people don't have any kind of money in the bank or savings when they come to talk to us about investing and then three, open up a separate account and start really figuring out how much you can sock away for a down payment on a house. Now, what Tim also mentioned may be a fourth goal. One of the things that we like to remind people, when you have a debt, maybe it's credit card debt, maybe it's student loan debt, maybe it's a car payment. The bill that you receive every month is the minimum payment. You can always pay more. And that would be a good way to eliminate that debt even faster. That improves your cash flow.

Tim Mullooly: Right. And just piggy backing off of that, we're going to move right into the second question which asks "Why is paying off debt always the biggest priority to advisors?" The summary says I have been an active follower of this site and have been around enough financial professionals in my time. One thing I always see and hear is advisors recommending that their clients pay off their debts above all else. Paying off debt seems to be advised over investing, saving, acquiring a loan, a home purchase, etc. Why is it that advisors and professionals are so firm on paying off debts before other options? Is there a specific reason? I get that paying off one's debt is crucial but feel there are other options that should be at least considered as a primary goal for an individual's finances. Are there any advisors who have a similar mindset to mine?

Tom Mullooly: There probably are other advisors who have a similar mindset to the person who wrote in the question, but you're not going to find them working at Mullooly Asset Management.

Tim Mullooly: Definitely not.

Tom Mullooly: One thing, not to get biblical on everybody but remember, you are a slave to debt. So whoever lent you money, they own you. They own you. You have to make that payment every single month. I don't know why, even with interest rates at historic lows, I don't know why going into debt makes much sense at all.

Tim Mullooly: Once you get yourself out of debt, the freedom that you have of not having that debt hanging over your shoulder every day, it's worth its weight in gold.

Tom Mullooly: So imagine that you have a job where you have say a salary of $75,000. And after taxes, your 401k contribution, paying for your medical, maybe you're bringing home $4,000 a month. Out of that $4,000 a month, you have a $500 debt payment. Maybe it's a car, maybe it's a student loan. But more than 10% of your free cash flow is going to pay down debt. You are giving yourself, once you eliminate that debt, you are giving yourself a more than 10% increase in cash flow. What can you do with that? Can you save $500 a month that's $6,000 a year. So you could fund a retirement account. You could do a lot of things with that money. It's just the mindset of not being a slave to debt.

Tim Mullooly: Once you get rid of that debt it's like giving yourself a raise without actually getting a raise. Just more money in your pocket and gives you more options to do better things than pay some company the debt that you've been building up.

Tom Mullooly: Plus the interest.

Tim Mullooly: Right.

Tom Mullooly: Sure. So one of the little tools that I have used with clients in the past is when they tell me that they're finishing a debt and they've been paying say $500 a month on a particular debt, I ask them what are they going to do next month when they don't have this debt to pay? Well I'm going to enjoy putting that money in my pocket. We know that $500 a month, it's $125 bucks a week, that can easily slip through your fingers right out of your pocket. So as a reminder I tell clients, keep that payment going, but instead of making it out to ABC debt company, write it out to yourself and put it in the bank or put it in your investment account, but continue to make that payment. So you're already in the habit of writing the check, just write it out to yourself now. It's a great way to force yourself to continue savings. Good question.

Tim Mullooly: Moving on, the next question asks "Which investment strategy should I follow through on?"

Tom Mullooly: Okay before we get to this question, I've already seen the preview of it so I'm going to just lay down on the couch first. This is a good one.

Tim Mullooly: Okay, the summary goes on to say "I need guidance on my investment strategy. I'm considering two strategies and need a professional to guide me through the pros and cons for each of them. My first strategy is to do short term investments by selling a stock as soon as I have a 3% gain on that stock, and then re-invest the money on another stock. Assuming that each stock can go up by 3% within one month, my return will be roughly 40% per year with the compound effects. I understand that things do not always come out as planned, so my conservative target return is 20%. My second strategy is to do long term investments by buying stocks that have good dividend history and hold it for a long term. I don't expect to use the money in my brokerage account to cover any monthly expenses so either way will work as long as the money can grow. My investment goal is to maximize the take home gain after tax."

Tom Mullooly: All right so this is in every podcast we have our big sigh, and this is it.

Tim Mullooly: This is a mega sigh.

Tom Mullooly: Mega sigh like oh my goodness, this is really painful to even hear.

Tim Mullooly: I was trying to hold back the judgment in the tone of my voice while I was reading the question but wow.

Tom Mullooly: So let's take the first strategy. My first strategy is to do short term investments by selling a stock as soon as I have a 3% gain and then re-invest the money on another stock. And then this person goes on to say assuming each stock can go up by 3% within one month, my return will be roughly 40% per year.

Tim Mullooly: If this person can successfully do that strategy, I want to give my money to them.

Tom Mullooly: If stocks go up by 3% a month, that's 36% on a calendar, 12 months. Okay. Why would we even talk to clients? We would just do this on our own. And furthermore, why would we sell things that are going up 36% a year? We wouldn't sell anything, why would we sell anything that doesn't make any sense. So the first problem that I have is I'm going to sell a stock as soon as it gets a 3% gain. Alright. When I got started in the business, your commission was 2% on the way in and on the way out. So back in the old days, 3% wouldn't even cover your cost. So you are no closer to making money, you were losing money. And then just hop onto another stock that goes up 3% a month.

Tim Mullooly: Just like that, it's easy.

Tom Mullooly: There's other things to consider. Like if you take some sort of short term trading strategy and please if you're going to do this, call it what it is. It's short term trading, it's not investing. You're giving investing a really bad name by doing this. So you're overlooking the cost of trading. Now compared to 30 years ago the cost of trading is, you need a microscope to see the numbers now. It's so efficient now to buy and sell securities. I mean you can do them at most brokerage firms now for less than $10, at almost every firm. They're also overlooking something really really big. Taxes.

Tim Mullooly: You're going to have short term capital gains if you're selling stocks every month that go up 3% and then you flip it.

Tom Mullooly: Right. And ordinary short term capital gains are taxed at your income tax bracket. So if you're in the 25% tax bracket, 25% is going out the door in taxes. You're in the 31% tax bracket? Figure it out. You're only keeping 69% of what you actually made after costs so we would immediately dismiss your first option as not even an option. I'm amazed though that they say in the beginning of their letter that they need a professional to guide me through the pros and cons for each one. So let's look at the second option. Second option is buy stocks that have a good dividend history and hold it for a long term.

Tim Mullooly: After reading this question a couple times, I'm curious if this is some kind of joke or something. Because the first strategy is so outrageous to us. And the second one is fine. A buy and hold dividend stocks.

Tom Mullooly: Sure, especially if you're reinvesting the dividends back into the company stock, that's great.

Tim Mullooly: You're not going to use any of the money in the brokerage account to cover monthly expenses so you have a long time horizon to let them grow and collect dividends.

Tom Mullooly: Sounds great.

Tim Mullooly: Yeah I don't seen anything without knowing more about your situation, I don't see anything wrong with that. But just the polarizing opposites of the types of strategies there is crazy. Why were those the only two strategies that you came up with out of the different number, there's hundreds of different strategies you could go with, and this person landed on two of the most opposite ones out there.

Tom Mullooly: Well my comment as we wrap up this question and go on to another one is thanks for the laugh. So ...

Tim Mullooly: Hopefully you pick strategy two, hopefully.

Tom Mullooly: Tim the next question that I want to get to is what do I do with excess credit cards that I don't use. So a little more information. For years this person wrote in, for years I played the zero percent balance transfer game. Now I find myself with 15 credit cards of which I'm only using two. My credit score is around 800. I'm told closing them out will drop my score. What do I do? I'm 66 years old and I do carry a balance on one of the two cards that I use due to medical expenses. So how do we help this guy?

Tim Mullooly: I think this person wasn't getting the whole story when he said he was told closing them out will drop my score. While that is true, it's not like it's going to drop your score from 800 down to 530. And carrying 13 credit cards that you're not using is a lot. So I would say close a handful of them. I'm not saying close every single one of them but you know. Walking around with 13 unused credit cards is not ideal.

Tom Mullooly: I think there's something else that a lot of people don't understand. When they hear credit score, they kind of think of it like golf score. Or some other score. You want the best score possible, so your credit score will never be perfect. It will never be perfect. And they don't give you a medal if you achieve some kind of perfect credit score.

Tim Mullooly: Right you can't win, you can't be the winner of credit score. That's not a thing.

Tom Mullooly: And so what a lot of people misunderstand about credit score is that it is not necessarily your ability to get more and more debt capacity. It's how, your credit score reflects how you manage the debt that you have. You know if you have a lot of potential debt that you could have, I mean if you ran up 15 credit cards based on your income, your credit score will drop like a rock. Because you'll have too much debt or too much debt capacity based on your income. And that's something else that I want to point out. This person wrote in with this question also added a little detail that's very important, they said they're 66 years old. So without knowing anything more than what the person wrote in, we don't anticipate that someone that's 66 years old is going to be buying a house. Maybe they buy a car, but that's a collateralized asset. There's an asset behind it. How much debt are they going to need going forward at 66 years old? I think credit score in your mid 60's should be less important.

Tim Mullooly: At that point in your life you've most likely gone through all of the bigger reasons to use your credit score. So again, it's not as important as it would be if this person was say 36 years old.

Tom Mullooly: Right. So one of the things that's happened a lot in the last 10 years since the credit bust in 2007 and 2008 is now these credit card companies are looking at people's profiles and their saying, you know you're 66 years old maybe you're retired living on a fixed income, maybe they'll use your Equifax credit report that we talked about on a previous podcast. And they'll look at this and say this person has too much debt capacity for the amount of income that they show, so we're going to voluntarily cut your credit limit from $15,000 on our card down to $1000. They're basically telling you have the capacity for too much debt out there, we don't want you blowing up on us, so credit card companies are getting a little smarter in terms of how they hand out credit and how they manage credit on the other side for you. But at 66 years old I think the real question is how much do you really need?

Tim Mullooly: Right, agreed.

Tom Mullooly: So Tim it looks like we have one more question.

Tim Mullooly: Okay so the last question for today's episode is going to be "How has the use of the internet impacted the general populations inclination to invest?" The summary goes on to say "Before the internet was so predominantly used, I imagine it was much harder for people to understand and execute investing. Even with sites like Investopedia and others, it is difficult to fully grasp all there is to know about investing and the markets. However now with all the readily available information, any investment advice or question can be accessed by a couple clicks of a mouse. How is all this accessible information and the internet change the way people invest?"

Tom Mullooly: Okay so really to answer this question I just want to take people on a walk down memory lane, and I promise it won't be long. When I got started in the business in the mid 80's, if you wanted to get a stock quote, you had to call a broker or you had to be standing outside one of Fidelity's new offices on Park Avenue and stand there for 30 minutes and wait for the ticker for your stock to scroll by, and you better not blink because you could miss it. So in the mid-80's they started Financial News Network. This was the grand-daddy before CNBC. And Financial News Network used to have the ticker scrolling on the bottom. And again, if you missed it when your stock went by on the bottom, you still had to call a broker and find out what the quote was on a stock. Otherwise you had to look it up in the paper the next day. That's the information, that's the way information was dispersed. When as a broker if we recommended a stock to a client they a lot of times the investors would say send me a tear sheet.

S&P, standard and poor’s, used to put together a profiled and they would update it every 90 days on companies on their financials and a short little discussion on what they did. And they would give you some historical information. They really wouldn't give you any kind of projections as far as what's going on, but clients would say send me the tear sheet. And so we would have to go into the library, pull the sheet out of the binder, copy it, and put it in the mail to the clients. Then companies had their own research reports and depending on how quickly you could get the research report that was your access to information. So fast forward into the late 90's on our little trip down memory lane. And I'm driving to work one day and I'm driving down the garden state parkway. I used to get into the office early at seven o'clock because they would start the research call and it would be piped in to all the branches. And you would hear what stocks were upgraded, downgraded, what earnings forecast changed, you'd find out basically what the company's thinking and that was great information to take to your clients throughout the day.

So imagine my surprise one day in the late 90's I'm driving to work and I hear it's not even seven o'clock in the morning and I hear on the news that my firm, which I'm not going to name, but my firm downgraded the stock of XYZ based on a meeting with the management. Now my own research meeting was getting scalped. That information was being out there. Now fast forward to today, there is information everywhere.

In fact, I would venture to say and maybe you'll agree with me Tim, that there's too much information out there.

Tim Mullooly: Absolutely. And not everything you read on the internet is true. I'm sure that's not news to some of you listening but over the last couple months there's been this term called fake news out there, and it actually, people put out these news stories that are not exactly true about a stock or 100% the real truth. If someone is a short seller of a stock and they want the stock to go down so their investment works out for them. They're going to spin a news story in a certain way to make it sound the way that they want it to sound. And it's hard for individual people out there to be able to decipher what's true, what's not. It's even hard for professionals out there to sometimes decipher which sources are telling the 100% right story.

Tom Mullooly: Right and also you're going to hear different comments from different points of view. So Jim Cramer maybe talking about what's going to happen in the next two weeks with a company before they report their earnings. A research analyst at a big Wall Street firm may say over the next 10 years we really like this company. And so everyone's got a different perspective and it's probably not yours. So some people are interested in what's going to happen between now and the next statement getting printed.

And some people are interested in what's going to happen over the next two or three years. Everyone has a different perspective, that's part of the reason why many years ago I started incorporating the use of point and figure charts into our practice because the ultimate indicator for us is price.

One of the things that we try to emphasize with our clients is that there's always somebody out there who's got better access, more information to news. And can act on that. And so we accept that some people have better information as a fact of life. And so what happens with the news is more important than the news itself. And so we don't get hung up on this earnings report or this economic report because how stocks and how the market reacts is far more important for our future than anything else. Good question, kind of nebulous but it gave us an opportunity to talk about a lot of, there's too much information out there. And yeah there is some fake news going on. So that's a wrap on episode 197 we appreciate you listening and tune in again for our next podcast 198.