Ep17: What Are Top Advisors Saying About the Market?

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PATTI BRENNAN: Hi, folks! Welcome back to the "Patti Brennan Show." Hey, whether you have $20 or $20 million, this show is for those of you who want to protect, grow, and use your assets to live your very best lives.

Today, we have Brad Everett, Chief Investment Officer of Key Financial. Brad is a regular on this show. He brings so much to the table and wait until you hear what he has been learning over the last month or so, so welcome.

BRAD EVERETT: Thank you, Patti. Thanks for having me.

PATTI: Let me give you a feel for what today's show is going to be all about. Doing that, the course of it in a calendar year, I go, Brad goes, my team and I go to between 20 and 30 conferences on all different types of subjects.

This has been especially true. We've been to a lot of conferences in the last month or so. I thought it would be a really good idea Brad, for you and I to have a conversation about some of the things that you learned in the conferences that you went to and I'll share with you as well.

We have this investment committee and we did this for the investment committee meeting last week. I thought our listeners would probably want to hear this stuff too.

BRAD: Yeah absolutely. I think what our clients think about are the same things that we think about. It's the same thing that other advisers think about and also portfolios...

PATTI: Well, it's really interesting because over the past few years what's cool about this is that when I go to these conferences, we've got some visibility now. It's one thing to listen to some of these people on CNBC or Fox. Unfortunately for them they're just doing a 30 second soundbite. It's quite another to be able to pull them aside and say, "Hey, I know what you said on TV but tell me what you really think."

Then for them to be able to talk to a group of advisers for a full hour to do a deep dive on the subject, that they spent 30 seconds talking about. You got a much better understanding of what's going on in the various markets or the topic that they're discussing.

We're not going to spend an hour today but we are going to spend 20 minutes or so talking about some of the highlights that we've gotten out of the past three or four conferences, that Brad and I have attended.

Brad, let's start with you. I think that some of the things that you brought back to the investment committee really had to do with more economic information, rather than market, although as we all know the economy affects the markets and vice versa. What comes to mind in terms of some of the things that that you brought back?

BRAD: Yeah. I think there are really four or five major themes that just kind of repeat and repeat. Obviously on a lot of people's mind is trade talks with China, it's a big one. We've got a new election cycle starting, that'll be obviously become more and more of a conversation going forward.

Our economic health, is a recession looming or not? The Federal Reserve has maybe slowed down, but that's always on top of people's minds and the never ending, active versus passive debate is something that never seems to go away.

PATTI: Yeah, it never goes away and never will go away. And I think that it's important for us to discuss it for our listeners today, because they're hearing it as well. So let's go back to the trade war with China. I think that the massive drop that occurred a few Mondays ago was really scary for a lot of our listeners, and I think that there's some misunderstanding as it relates to tariffs and the impact on Americans as well as the Chinese. Let's talk about that.

BRAD: Sure. I think you could you could easily make the argument that the odds of a deal getting done has been priced into the market. The world assumes that a deal will get done, so any kind of news that it would be stalled or maybe not ever accomplished at all is going to send the market down.

If they announce today that a deal was done and everything was solved, you probably wouldn't see much of an effect on the upside. But if they said we're not going to have this figured out for a year, the market may have a pretty big week of drops. I think the world is kind of assuming that it does get done. I think it's probably in both countries' interests to get it done, but to this point it hasn't.

I think in a lot of ways it's something that is a political issue and an economic issue. We have a much stronger negotiating position when we are announcing large numbers and great economic growth, but if that changes and earnings start to decline and recession gets closer, I don't think that we have such a powerful ground to stand on and you might find resolution come sooner rather than later.

PATTI: Which is exactly what China's position is, because their economy has slowed down dramatically since the trade war has begun.

BRAD: Sure.

PATTI: I think it's also interesting to bring up that on a relative basis, the size of the tariffs aren't so large.

BRAD: Right.

PATTI: We hear our President talking about billions and billions of dollars and a 25 percent tariff does sound like a lot of money, but there are certain industries, there are certain areas of our economy that are affected more than others. I think that the areas and the people are really affected mostly are really in President Trump's major voting base and we've got to be conscious of that.

I also think that we've got to understand what that really means for consumers. Terrorists really are not good for our economy, are they?

BRAD: Yeah.

PATTI: We hear about billions and billions of dollars coming into the federal government and of course we all hear about deficits and the federal debt and all of that. And so you hear billions and billions of dollars coming to the government. Here's a newsflash, guys, that you should be aware of.

Though that money is not coming from China, it's coming really from one of two ways. Number one, if I'm Tim Cook and I've got to make iPhone 20 and I've got to figure out where that's going to be manufactured, he's looking at a 25 percent tariff on manufacturing and assemblies and putting these iPhones together in China.

So he's got one of two choices. He's either going to assume that additional cost, which will translate into lower profits for Apple. Lower profits for Apple mean higher multiples, which means the stock is richly valued. So there is more risk in the stock and the stock market in general.

The other way that it could be paid for is by raising the cost of the iPhones. And it's not going to be one or the other, it's going to be a combination of the two. At the end of the day, it's going to be coming out of our pockets one way or the other.

BRAD: He's a good example too, because I think Apple almost has the decision then to why not just build a factory in China, make the entire phone in China, and then just sell it to the people that live in China. It never has to be imported back into the United States. I think that some of the larger companies have that choice to make too.

PATTI: Again, I think that's why this trade war is so difficult because is China going to let them do that? How open is China to that? They've got their own phone manufacturer that we're having issues with here in the United States and it's creating even more tensions between the two nations.

BRAD: I think in a lot of ways, it's just the size of the tariff or this trade war, as you call it, is not very great. I think it's just uncertainty and uncertainty always causes volatility.

PATTI: And people love to talk about it.

BRAD: Right.

PATTI: People love to talk about it. Although, let's talk a little bit about what China is doing in terms of, we hear this all the time, China is cheating. Isn't it true – and maybe you can tell me if this is what you heard in your conferences – isn't it true that that's really the issue? That it's really not the industry specific. It's just that China is cheating.

BRAD: Sure.

PATTI: Let's talk about what are they cheating about. What are they doing?

BRAD: Yeah. I guess my understanding is it's primarily intellectual capital. They don't have the protections against stealing code snippets or stealing user interfaces or things like that. Anything that we've done here and it's very difficult for a US company to prosecute over there. So it...

PATTI: That's a really good point. It's interesting, because we have a senior executive from one of the pharmaceutical companies that literally got to the one yard line with China to bring a major deal over from the United States to China, and they decided not to at the very last minute, because they didn't have any protection on their patents.

Another pharmaceutical company ended up going ahead then and doing a deal with China only to regret it. It was a disaster for that pharmaceutical company and they wished they had never done it.

That's really what we're talking about. Companies that do business in China don't have the protections that we have here. They have access to the coding and the technology and you pretty much have to open up everything to the Chinese government.

The worry, of course, and what's happened is they've stolen it and put that company out of business as it relates to the Chinese market.

Who knows what they're going to do with that over the long run. That's the issue that they have and that's a very difficult problem to solve.

BRAD: Yeah, that's why I say, I think part of the problem is solving the problem. This is actually interesting, I never thought about it this way, but someone mentioned that this is really challenging without becoming overly political. It's kind of an interesting political debate, has really challenged Republican orthodoxy. Right?

China's cheating, but anything we do to retaliate is also cheating. If you really believe that the free market is the pure force that runs the economies of the world, then retaliating is just as bad as the original crime.

PATTI: Yeah, because when you think about it, the tariffs are a form of manipulation or manipulating behavior.

BRAD: Exactly. Right.

PATTI: We accuse them of manipulating their currency, which they did for many, many years. They've eased up on that. Still, it all does fly in the face of this thing called free market economies, doesn't it?

BRAD: Yeah. It's interesting.

PATTI: It's a philosophical debate, as well. Tell me what else, what's the latest in terms of what's going on with the election? That's beginning to heat up, and I think even the Sunday shows are talking about that. What are you hearing? How important is that becoming?

BRAD: It's really important. I saw Conan O'Brien made a joke on Twitter a couple of weeks ago, joking that there is a Democratic candidate for every voter in the United States, as he sort it out, who ends up rising to the top. Right now, there are about 45 to 50 candidates. They're all...

[crosstalk]

PATTI: I was going to say it feels like the Republicans from four years ago because the Republicans had a ton of candidates, as well. They dilute their message by doing that.

It's also interesting what we're hearing about this whole talk about impeachment, and fascinating, what you heard as it relates to this discussion of impeachment.

BRAD: Yes. That was one topic that they referenced. Even more interesting than impeachment is how they decide whether that's a feasible strategy. I had not noticed this until I brought it up, but people in office, currently, are the only ones that bring impeachment up.

Throughout the course of many, many elections, that's not as relevant as what candidates are talking about. That's truly what's interesting to the public because they're the ones that are in town hall meetings answering questions from voters.

Candidates are not bringing up impeachment at all. That's a sign that it's probably not really on voter's minds. They probably don't care, one way or another.

PATTI: It is interesting. A candidate who really wants to get a good run for the election, they recognize that that is a ladder that would be on the wrong wall. That they really want to talk about things that are important to the voters, which is really how's that for a concept.

BRAD: Which is interesting. I've never thought before about that kind of dynamic that the candidates are actually far closer to the polls than people that are in office.

You want to look at the differences between what the candidates are talking about compared to what people are already in office are talking about. Those mismatches are where the important differences lie.

PATTI: Fascinating. The Federal Reserve, I know in my conferences, pretty much everybody is saying that the Fed is done, that they're not going to continue to increase interest rates. How about at yours?

BRAD: It's astounding that for years and years, we've talked about how rates have to rise, and it's ridiculous. They can do nothing but go up, and they stopped.

It seems like the market has priced in, even possibly dropping just a little closer to home. There's two people in the office, right now, that are in the process of getting new homes. One of those people has been in a constant battle with his mortgage broker, about locking in a rate lock for the last 9 to 12 months as his house is being built.

Someone else bought a house about a year later, and has a rate where he originally locked in that expired several times. Rates are doing very little, nothing exciting. Possibly even dropped but they've been very flat, and likely will be for a while.

PATTI: It is interesting. With one of those individuals, the rates actually were probably about half a point higher than they are today.

BRAD: Amazing.

PATTI: The mortgage rates have actually gone down, which is actually a good segue in the economy, in terms of what people are talking about in terms of the economy and do we have a looming recession?

The Federal Reserve stops increasing interest rates because they don't want to force us, or they don't want to push us into a recession. They're "pausing right now." What are you hearing in terms of that risk?

BRAD: There's always five to six major factors that usually tend to predict recessions pretty well. Just that the timing is almost impossible to figure out. There's these things that usually have to happen first and very few of them have. They're all within historical norms. Nothing stands out as being a real reason for concern.

There's probably two areas that seem to be a little overheated or probably excessive compared to historical norms. One is mergers and acquisitions and IPOs. We're seeing a flurry of IPOs again that seem to be overpriced. Very few of them can sustain their IPO price. There's a lot of them.

PATTI: There sure are. You look at Lyft and Uber. Both of those companies, great companies, wonderful product or service that they're providing. The stock has gone down since the day they opened. That is a late cycle sign that something might be going on.

BRAD: That seems a little frothy. The other one that's starting to grow pretty quickly is corporate debt. When you see that, you have to look and say, "All right. Why?"

There's good reasons for corporate debt and there's bad reasons. It seems the recent increases in debt are not necessarily to increase productivity or expansion, but more for buying shares back and for paying dividends and things like that.

If you think of a company like AT&T, that borrows and pays a giant dividend, and they borrow again and pay a giant dividend. They're not growing in any sense.

PATTI: That's not a good use of debt. That's for sure.

BRAD: Right.

PATTI: It was interesting in the conferences that I went to. It was fascinating. I was up in New York City for "Barron's" and "The Wall Street Journal." They had a round table. The round table was 12 of the top advisers supposedly in the country.

It was fascinating to hear what my colleagues were doing and how similar it was to what we're doing. One of the people, there's a gentleman there from MFS. His name is Brad Rutan. He did a great job of framing what's going on in the bond market right now.

For example, over 50 percent of the bond market right now, Brad, is BBB or above. BBB is just above the junk bond status. It's just tippy top. It's really the bottom rung of investment grade. Who's doing these ratings? Of course, it's Moody's, Standard & Poor's. Who's paying for these ratings? Of course, the companies themselves.

They know that if they move them down a notch, that company is going to be in junk bond status, and they're going to have significantly higher borrowing costs. 50 percent of the bond market is just above junk bond status. That's a little scary.

The estimate was about $300 billion of that debt. If you think about the junk bond market being at one trillion. If you think that Moody's did what a lot of people think they should do, which is downgrade those bonds, you'd be flooding that market with a ton of new supply. What happens then? The price goes down.

We have to be very cognizant that there is companies that are teetering there. As with everything, you're going to learn that you know you got to look underneath the hood.

It's funny. I was describing this in our investment committee meeting. It's a long story, but my daughter and I were in the car. We were at a light. It was a red light.

She said, "Mom, I've got this light that's going on and off. It's a red on and off exclamation point on my dashboard." I said, "Kelly, how long has it been going on?" She said, "It used to be yellow, but now it's red." We drove 300 feet. At the next red light, all of a sudden, we saw smoke billowing out from underneath the hood of the car, and the car was totaled. There was no recovering from that.

We have to be cognizant of the fact and wonder, "Gee, is there a red exclamation point that's beaming on and off on our dashboard?" Most importantly, as with all of this, we've got to look under the hood, and see what's going on.

The other thing that I found fascinating was as it relates to the municipal bond market. Here's a little interesting fact for you. I know you know this, because you're a chief investment officer, but 70 percent of the municipal bond market is not rated.

Again, understand how all these things work.

If a municipal bond wants to put out a new issue, they can go to Moody's and say, "What do you think? Are we investment grade? We'd like you to rate us and, by the way, we will pay you thousands and thousands, maybe hundreds of thousands of dollars, to rate us."

If they already know that they're not going to get a good rating, what's the chance that they're going to pay all that money to get a below investment grade rating? 70 percent of the municipal bond market is not rated. Why is that relevant?

As you and I always talk about as we look at bonds, bonds represent debt. If I borrow money from you, you'd want to make sure that I'm going to pay you back. If I don't pay you back, whether it be the interest payments or the principle, then that's called a default. The default rates on municipal bonds are lower than they are on corporate bonds and other types of debt, right?

BRAD: Sure.

PATTI: Basically when you look at corporate bonds verses municipal bonds and you think about the ratings and you think about the default rates, well that's fine and dandy, but we don't get default rates on bonds that are not rated.

BRAD: There is not included.

PATTI: They're not included, so you're looking at default rates for only 30 percent of the market.

BRAD: Right.

PATTI: So we have to be really careful about municipal bonds. Don't assume that these municipalities are going to be able to continue to pay. And in fact, many of them are having difficulty and will if and when we end up going into that recession.

BRAD: Right. And you said, I thought you mentioned earlier that there was a very low number of them that actually had insurance on their bonds too, much lower than you'd expect.

PATTI: Well yeah, it used to be. You know, 30 years ago when I first started, almost all municipal bonds had insurance, bond insurance. Now only five percent of the market has bond insurance. Now you don't have anything, no net underneath you to continue making those payments and making sure that the bond doesn't default. It's a whole new market. It is not your grandmother's municipal bond anymore.

I also thought it was interesting, Brad, in our round table. Again, these are the top advisers in the country and I would think that...And some of them are from the wirehouses, they're in private wealth management, what have you, and they're doing laddered bond portfolios etc. None of them are.

They are going to actively traded bond funds, not even ETFs. They're going to active management because they want someone who is looking at the financials and deciding, do we buy this bond, do we continue to hold these other bonds, and making those decisions on a daily basis to make sure that the default rate on their portfolio remains very very low.

In terms of this active versus passive debate, what exactly were you learning when you were...?

BRAD: I think there's a few levels, a few ways to look at it. I guess the line, apparently I was the last person that ever heard this line because you knew it right away, but that somebody quoted, “The average money manager can’t beat the market, but also the average American can’t dunk a basketball either. But there’s a whole league full of people that can.”

In my mind, to be an active manager you would be rewarded for the skill of being able to piece together what’s happening in the real world now.

You’ve got this mosaic of data that comes in you can go out and talk to people in the streets and you can figure out what’s going on now and interpret a future significantly different than the way others would see it.

These kind of expectations are priced in. If you see it differently than everybody else and you’re correct, you win and you make more money of a higher rate of return.

That seems to me like a skill that you can learn, you can be taught, and you can get better at. I wouldn’t dismiss the idea that somebody actually could help perform on that basis.

PATTI: OK, so how do you answer the argument that the average mutual fund manager, the average active manager doesn’t do any better than their index? In fact, most of them do much worse, even before their fees and certainly net of their fees. How do you answer that debate?

BRAD: It’s an interesting use of data. I think if you have the average manager without fees, they probably are very close to the average. The average intelligence of all the people in the world is probably pretty close to average. That’s what average means. You add up all these guys and its average and then you take the fee off and of course they’re going to be on average below that.

But there is a group of people that have phenomenal research capabilities. It’s not just luck or skill of one person, it’s a commitment to research. These are things that there are large fund families that have that a lot of people don’t have.

There is a consistency though or sort of a, I’m drawing a blank on the word, not a resilience, but there is a repeatable list of people that are in the top group of investors. It’s possible that’s luck, but I wouldn’t expect to keep seeing the same group there over and over and over again.

PATTI: I find it’s interesting because we talk about active share, that the ones that actually are in the top 10 percent or even the top 20 percent, actually their portfolios look very different than their index. They are really researching and finding opportunities that the index hasn’t included quite yet.

BRAD: Yeah, I think benchmarks can be a little bit of a silly comparison because if you want to be the benchmark, you have to be different from it. The closer you are to a benchmark, the more likely you are to have the exact same rate of return. So at some point, you have to make some decisions to either not include something or to include something else. The more different you are, the more opportunity there is for you to either lose to that or beat it.

I heard a recent argument, again it was actually at the American West Conference, arguing for objective based benchmarks rather than just an index based.

It's all well and good to compare something to the S&P, but looking back at the last 10 years doesn't tell you if you met your goal or not. It's kind of very delineated saying the last 10 years is the only thing that mattered. Today is the last day that matters, not the fact that I need to continue to hold this investment for another 20 years after today.

PATTI: It's such a good point. Point number one is, it's time based. We can always pick a period of time, literally on a daily basis, where a particular fund looks better or worse than the index. So it's really time based. It's amazing how you can manipulate those numbers. Again, we look at the process, etc.

Also secondly, we really want to focus on outcomes, not performance. What is the outcome that you're looking for because if you're looking for the highest outcome, you're going to also have to accept a lot of volatility and a lot of risk. By the way, risk is one of those intangible words. Risk in English means, the risk of you not being able to stay retired. That's a big risk.

You've got to ask yourself, do you really want to have 98 percent of your money in the S&P 500 Fund? I'm not so sure if there is a risk that you could run out of money when you're 78. Risk is a very real thing, it's the outcome. What's the outcome that you are trying to achieve and let's make that real by making sure you've got a portfolio that is resilient in every economic environment.

Hey Brad, I don't know about you, I don't know what's going to happen in the economy next week, next month, next year. We want to position and we want our listeners to be positioned so that they can weather anything that the world has to throw at us. That they're going to be fine and they're going to get the outcomes that they're looking for.

So active versus passive, I don't know about you, I'm not so sure that's the right debate. I think the right debate is, are we hyper focused on this thing called the portfolio or should we be more focused on what is it in your life that gives you meaning? What do you need from a cash flow perspective? What's your tax situation? And how can we manage the portfolio to help you accomplish all of the above?

What do you think Brad, is that a pretty good summary of the business model here?

BRAD: I think you're right on there.

PATTI: All right, so that sounds great. Well, that is terrific. Folks, thank you so much for joining us today. Brad, as always thank you for your intellectual capital, you did a great job. And of course you're always adding in your humor, you are one of a kind when it comes to those soundbites. That's it for today's show.

If you like what you've heard, please go ahead and head over to our website at keyfinancialinc.com. You can schedule a call with me and with Brad. You know what, while you're at it hit subscribe, because if you liked today's show, I'm hoping that you're going to like not only today's show, but all of the other shows that we've been doing. We've been getting amazing feedback from these shows.

The topics are very different, people aren't hearing about some of these things and we try to give it to you real. That's really what it's all about is to give it to you real and give you actionable steps that you can take.

By the way, actionable for today's show is look under the hood. Don't believe everything that you read. Don't necessarily listen to somebody's soundbite on CNBC and think, "OK, I gotta do that." There is not just an hour, there is days and weeks of additional information that you would need in order to apply whatever it is that you're hearing in that 30 second clip.

If you want to learn more, give us a call, we're happy to help. Again, I am Patti Brennan and I will see you in the next show.