Fresh Invest: Leveling up
Season 2, Episode 14 Transcript

Alex Lieberman, Co-founder and Executive Chairman of Morning Brew Hey, there. I'm Alex Lieberman, co-founder and executive chairman of Morning Brew. This is season two of Fresh Invest, the investing podcast sponsored by Fidelity Investments and powered by Morning Brew. For this episode, I'm going to pull out all the stops. We're going to run down a bunch of investing tools and techniques you might want to try now that you've got the basics and a lot of the intermediates from the previous 13 episodes.

Alex Here we are at Episode 14 of season two of Fresh Invest. We've lasered in on a whole bunch of different assets and investing techniques that can help you craft a portfolio that makes sense for your goals. So we're done with the intro and the intermediate classes. This time, we're going to get a brief feel of the advanced levels. It's like we're dropping in on a few different senior seminars just long enough to get a taste, but definitely before any quizzes can be popped on us.

Alex Because this stuff is advanced, I'd recommend you do more than listening to this episode before you get involved in the tools we talk about. But you'll definitely get a good foundation. Joining me to level up is Heather Knight.

Alex Heather, thank you again for joining the show.

Heather Knight, Regional Brokerage Consultant at Fidelity Investments Thanks, Alex. I'm excited to be here.

Alex So, for anyone who missed the last episode, let's set the stage. Could you introduce yourself and explain what it is you do at Fidelity?

Heather Absolutely. As a regional brokerage consultant with Fidelity Investments, I support and work with individuals who tend to make their own decisions when it comes to investing. I like to think of myself as someone who will work together with clients as they begin their journey with Fidelity. Many of these clients are just putting their feet in the water with Fidelity or even new to investing in general. So most of my conversations are educational in nature and customized based on the unique needs of each individual and/or family.

Alex So, let's say one of those clients hypothetically comes to you and asks about this advanced investing concept of margin. Can you explain what investing on margin is, why it's useful, and also why it increases the risk profile of an investment.

Heather Sure thing. So high level, a margin loan allows you to borrow against the value of your securities that you already own. It's an interest-bearing loan that can be used to gain access to monies for a variety of reasons — buying investments on credit or even non-investment needs. For example, you might be looking to borrow cash from your portfolio rather than selling the securities to generate cash flow. You could simply borrow the cash against those securities instead.

Heather Many of the clients that use margin to buy additional securities, they like to do that because they don't have to make the deposit right away as well. Think of this as leverage. You're leveraging your assets to buy more assets, and certainly this can amplify your risk or your return. And as with anything in life, Alex, there are risks. So, as you mentioned, it can be risky.

Heather Before anyone applies for margin, one would want to know what their investment objectives are and review that — their finances, risk tolerance. And make sure using margin aligns with their financial goals and time frames within their plan. As I mentioned, when leverage comes into play, you might see amplified losses if the securities in your account decline in value.

Heather There are critical components to margin one must know before using it. In this light, what's important to note is that margin accounts have varying requirements depending on the underlying securities. These are known as equity requirements. Margin calls can occur if the equity in one account falls too low, or a liquidation of securities could be possible even if that value goes a little too low.

Heather The equity in your account is the value of the securities less how much you owe the brokerage firm. Because the price of the securities can fluctuate, it's possible that you would be required to deposit cash or sell securities to make up the difference in that security if it fell in value. Brokers are not required to call you and let you know that your value has fallen below those minimums.

Heather And while your account may reflect the margin call and the amount of that said call, you want to be sure that you're working with a broker that gives you some of those abilities, or at least highlights, maybe alerts, to let you know where you're at. So it's critical to stay on top of your accounts, especially if you have a margin debit balance. And if you already have a margin account with Fidelity, we make it a little bit easier for you to monitor the portfolio, like I mentioned, using those alerts and that real-time balance information.

Alex Got it. So much to unpack there. Before we move on to the next topic, I just want to throw out an example to you and just understand if I'm thinking about it the right way. So let's say hypothetically, I have $1,000 in my account and I'm thinking about buying a single-name stock. And I'm, like, I want to not just be able to buy $1,000 worth of this stock, say I want to buy $2,000. I would borrow a thousand on margin, use the thousand I have in my account, and buy $2,000 of that stock.

Alex If that stock drops below a certain value, such that the amount of money I've put in drops below a certain value, at some point if it gets too low, what you're saying is that I would be margin called and have to come up with money to put more money in my account because now there's a risk to the platform on losing the money they had loaned me. Is that effectively how it works?

Heather That is absolutely how it works out. And, you know, thinking back just to something I mentioned before, that's why we want to be on top of our portfolio. And certainly you could take a quick step away and certainly find yourself in a situation, but absolutely.

Alex Awesome. So, we've broken down margin. Next up is fractional shares. And I feel like fractional shares have become popularized by a lot of upstart digital investing platforms. But could you just work through what exactly fractionalization, or fractional shares, are?

Heather Yeah, I'm so glad you asked, Alex. We call it stocks by slice. Some call it dollar-based investing. So let's say that you have $20,000 and that you'd like to invest after you do some research. Maybe you find a stock or an ETF and that trades for, let's say, $130 a share. Previously, you'd be able to buy 153 whole shares only. So thinking about 130 times 153, so that's slightly under that $20,000 budget that you have.

Heather Now with the ability to buy in fractions, you can actually purchase 153.8 shares — that exact dollar amount. I think it allows more investors to participate in the market as well. For example, my son, who now has the ability to buy $100 worth of his favorite stock, would choose to do that, where before, maybe, he wouldn't be able to buy a $1,000-priced stock in the past.

Alex Love it. So, you have the ability to buy a stock, even if you don't have as much money as the share price of the stock is worth. And that's what fractionalization allows for.

Heather You bet.

Alex Awesome. So we've talked about fractional shares. We've talked about investing on margin. Next up — definitely a confusing one to me — is swaps. What are swaps? Why should we care about what swaps are? Please break it down.

Heather Yeah, I got to say, Alex, from a personal experience in engaging independent retail investors over the last 20 years, I think investors need to understand products and vehicles that they use for exposure. So that's number one. I think that that hits a lot of different topics.

Heather When I'm asked specifically about swaps by a retail investor, my initial reaction is similar to when a novice investor wants to better understand the use of derivatives, for example, option contracts. High level, both vehicles offer, or have, contractual complexities that are nuances you might want to understand prior to exposing yourself to the potential risks associated.

Heather All that said, at the highest level, swaps are those contractual agreements between two counterparties, where they swap potential future cash flow but maintain exposure to whatever the underlying vehicle is used to generate that swap. There are various types of swaps. Many institutions run swap strategies in the currency space. The interest rate space as well. And the equity space, of course.

Alex Awesome. So, now I think we've fully loaded up both our listeners' brains and my brain. So, we're going to ask one more question and then we're going to let everyone allow the information to marinate. One question from a Fresh Invest listener is: Inflation is in the news more than ever. And, as an amateur investor, how should I, or anyone listening, be thinking about the impact that inflation may or may not have on our investing portfolios?

Heather So I think it's important to understand the definition of inflation first. Basically, inflation is the rise in prices that you pay for goods and services, and this truly affects all of us. Throughout the pandemic, we've seen this firsthand. Think about the used car prices or even going to the grocery store. I think too, the same food I've always bought for my dog is about $7 more a bag than it was last year.

Heather So, I now have to adjust my budget a bit in order to accommodate the price hikes. Believe it or not, some level of inflation is actually a sign that we have a healthy economy — in particular, wage inflation. That being said, it's really difficult to predict how inflation will affect different asset classes. Think of inflation as a phenomenon of cash being worth less today than it was yesterday due to decreased purchasing power.

Heather In regards to the effect that inflation has on investing, there are some considerations across different asset classes. As cycles ebb and flow — and often we see inflation hit commodity asset classes first — that could ripple across other markets and ultimately affect the asset classes in some form or fashion.

Heather The Federal Reserve has a dual mandate: achieve stable prices and also maximum employment. And think about that for a little bit. What does the Fed control? Well, short-term interest rates. When inflation rears its head, that Fed is often asked to be maintaining price stability, and that historically means higher rates.

Heather Another way of looking at this question might be, how do higher rates affect my investing? Well, we know that an inverse correlation between price and yield exists, meaning if rates are going up, prices of fixed payment investment vehicles like bonds will likely go down. The move occurs at varying rates depending on the maturity dates. Longer-dated bonds, meaning bonds toward the longer end of the yield curve, could see a more pronounced move down when rates go up.

Heather Visualize a teeter-totter, and how much higher or lower you go the further away you sit from that central area. Traditional bonds, corporate bonds, municipal treasuries — they typically pay a fixed amount of income each year, known as a coupon. When that inflation hits, the coupon payment, or that fixed income amount of income, may not be enough to pay for those goods—thinking back to that $7 [chuckles] more for my dog's food. It's going to cost us more today than it did in the past.

Heather So as an investor, I need to consider how inflation, or the changes to the rate in the environment, might affect my portfolio. In particular, I also need to consider that composition of my portfolio of which asset classes might be affected most. Depending on my circumstances, I might even change that portfolio. For the most part, stocks actually can be a hedge against inflation since they can actually generate returns in excess of that.

Heather The other thing to consider is the cost of raw materials, which could dip into corporate operating margins, and this would affect the price of the stock as well. Overall, companies will end up raising prices of its products to compensate for the cost, which is passed along to consumers, and so that companies can continue to maintain its margin.

Heather The danger here would be if demand for goods is less or weak. The consumer sentiment goes down and even high unemployment. Then companies who attempt to pass on those hikes for materials may find products being passed over, which could certainly affect the profits of the company and eventually impact potentially the stock price as well.

Alex That was a lot. So, as it relates to inflation, first thing that we talked about was budget and how, just literally from how you live, the cost of goods that you buy to feed your dog or feed your family literally could go up with inflation.

Alex Then there's the second piece of it which is thinking about it from a portfolio perspective and a portfolio construction perspective, because some financial instruments are more protected from inflation versus not protected. On one side, like we've talked about, fixed income instruments. You know, the relationship is as price goes up, yield goes down; as yield goes up, price goes down. Like, that is something for us to think about if interest rates are going up.

Alex By the same account, stocks traditionally are a strong hedge for inflation. They can actually generate returns in excess of inflation, which can be good to own stocks in an inflationary environment. And then even beyond that, just thinking about it like we think about it for ourselves — dog food to feed our dog increases in price — that has an impact on us. Companies, to create a product and distribute that product to consumers — if the raw goods to create that product cost more, that can obviously impact the budget or the profitability of the business as well.

Heather You got it. That's exactly it.

Alex Awesome. Well, Heather Knight, thank you for breaking down inflation. Thank you for breaking down swaps. Thank you for breaking down fractional shares, and thank you for breaking down margin. Really appreciate you joining Fresh Invest.

Heather Thanks again, Alex. Appreciate it.

Alex So that was a lot of ground we covered. Honestly, I feel like years of knowledge is packed into that one episode. Like I said, I just wanted to give you a taste of some of these more advanced concepts so you can decide for yourself whether you want to do more research and pursue them.

Alex Thank you so much for listening. And make sure to tune in next week where we recap our biggest takeaways and most interesting insights from this season of Fresh Invest. You don't want to miss it.

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