FINANCIAL PREPAREDNESS

"One of life's most painful moments comes when we must admit that we didn't do our homework, that we are not prepared." ~ Merlin Olsen

Issue #5
March 12, 2021

If you did not receive a previous issue, let me know I will resend it to you.

The Case Against Equities

The worst crime against working people is a company which fails to operate at a profit. ~ labor union leader Samuel Gompers

Traditionally, equities (stocks) has been the only asset class (out of stocks, bonds and cash) that has delivered a positive real (after inflation) after-tax average annual return. It has been one of the only avenues available to middle class Americans to create wealth over the long term. Many fortunes were made with equities, especially those that were purchased at an ideal time (when sentiment and valuations were low) and/or those that increased their dividend every year.

The reason that equities have a much higher real average annual return than bonds or cash is because they have significantly more risk. Stockholders receive whatever is left over after a company pays all of its expenses (including employee compensation, debt payments, and income taxes), which is called *free cash flow*. (Historically, Wall Street has tried to get investors to focus on earnings instead, since they are much easier for management to manipulate. Earnings are for accountants, free cash flow is for investors.) Free cash flow can be used to replace worn out equipment, pay dividends (great for investors), buy back stock (pitched as good for investors, but really great for management about to exercise their stock options), or invest in new projects that management believes have a positive net present value.

Often times, especially for smaller and less established companies—and during a recession or depression—a company will fail to earn a profit, in which case there is nothing left over for the shareholders. If the losses are large and/or sustained over years, the company will go bankrupt (the eventual fate of all companies) and the shareholders will get wiped out. When the stock market crashes (especially from the peak of a mania—like the one we're in now), the losses can be massive. For example, after the Dot Com bubble burst, the tech-heavy NASDAQ stock index lost 85% of its value.

Shareholders own the company and elect the board of directors, who hire and supervise the CEO, who runs the company on a day-to-day basis and reports to the board. I suppose that shareholders own the company because it would not exist without them, and their capital is completely at risk if the company goes bankrupt (whereas laid off employees merely have to find another job). Historically, labor has been plentiful but capital (which is placed at risk) has been scarce. So traditionally, the purpose of a corporation has been to maximize shareholder value (of course, one way it does that is by keeping its employees happy enough to stick around and be productive).

Unfortunately, as the book Money For Nothing: How the Failure of Corporate Boards Is Ruining American Business and Costing Us Trillions describes, corporate governance in the U.S. has been pretty awful (especially when the CEO is also the Chairman of the Board). In theory, the board of directors represents the shareholders and the CEO and management work for the board. In practice, the CEO/Chairman often stacks the board with cronies (or at least people who are not going to ask any tough questions or cause problems for the CEO).

With no real supervision, management then strip mines the company (at the expense of shareholders) by giving itself exorbitant compensation packages (including stock options--which dilute shareholders) and perks (e.g., corporate jets and travel, a fancy new headquarters, expense accounts). Management also often squanders the shareholders' money via empire building (acquiring other companies—usually for a rich premium near the top of the market—usually to justify a larger compensation package).

The problem is one of concentrated benefits (for management and a compliant/collusive board) and dispersed costs (for the shareholders). The rise of index funds and smallish accounts that belong to uninformed investors (such as 401(k)s) has exacerbated this problem because the average plan participant with $20,000 in a 401(k) plan that's invested in an S&P 500 index fund either doesn't know or doesn't care (which is rational given the dollar amount involved) that a certain company out of those 500 has a captured board that is allowing management to strip mine the company at the investor's expense. At the same time, management knows how to game the system (e.g., which compensation consultants to hire that will recommend exorbitant compensation packages) and can enjoy generous perks in relative privacy.

Therefore, it is best if shareholders can prevent management from squandering the company's free cash flow by having management use much of if not most of it to pay generous (and increasing) dividends to the shareholders. It also helps if management owns a significant percentage of the company, thus more closely aligning their interests with those of the shareholders.

I have enjoyed investing in equities over the years. It has been like a big detective mystery. There are so many factors to sleuth out—profitability, future growth, safety and growth of the dividend, valuation, investor sentiment, corporate governance, the economy, politics, taxes, regulation, etc. I spent years developing a massive spreadsheet that is automatically updated in real time with data from the stock market, as well as a proprietary scoring system that allowed me to identify the most attractive (and unattractive) stocks.

I said I "have enjoyed" instead of "enjoy" investing in equities because I believe that the age of equity investing is about to end, at least in the U.S. and probably Western Europe. Let's look at the reasons.

First, in August 2019, the Business Roundtable (a group of close to 200 CEOs, from mostly large companies) sought to redefine the purpose of a corporation away from "maximizing shareholder value." Now, a company has five purposes, and shareholders aren't mentioned until the last one, which is to "generate long-term value" (not "maximize") for shareholders. This is "stakeholder capitalism" that is being pushed by Klaus Schwab and the World Economic Forum as part of their Great Reset. Basically, corporations would pretty much become nonprofits (i.e., they would spend about 80% of their free cash flow on the first four purposes, leaving roughly 20% for shareholders).

Now I'm not here to argue about who should own a company or what its purpose(s) should be, because you and I are not going to decide that. But we do have to live in the world, regardless of which decisions get made, so I need to explain the consequences of this.

Nothing is free in this world (strange idea, I know), including the capital provided to a company from the sale of debt and equity. A company's cost of debt capital is equal to the interest rate it has to pay on the debt it issues. A company's cost of equity capital is equal to the expected total return (capital gains + dividends) from its stock. At the peak of a bull market, a company's cost of equity capital is low (lots of investors want to buy its stock even though it is richly valued), which is why companies often sell more shares then. At the bottom of a bear market, a company's cost of equity capital is high (few investors want to buy its stock even though it's cheap because the risk seems high).

Let's say that a company needs equity capital of $1 billion and it's expected to generate $100 million per year of free cash flow. That's a 10% return, which equity investors deem is acceptable given its risk, growth, etc. OK, so what happens if the company decides to divert 80% of its free cash flow to other "stakeholders"? Well, the company still needs $1 billion of equity capital, and investors still need to earn a return of 10% to justify putting their capital at risk. But free cash flow of $20 million to shareholders is a return of 2%, not 10%. So the price of the stock needs to decline by a massive amount in order to provide shareholders with a 10% return.

How would an 80% decline in the stock market affect the following?

- People's ability to retire (401(k) plans, IRAs, pension plans)
- companies' ability to raise equity capital (including the uncertainty created among investors by suddenly taking away about 80% of their free cash flow)
- government tax revenues and spending on welfare (unemployment benefits)
- interest rates and leverage (if the cost of equity capital goes sky high, companies will seek to substitute cheaper debt capital, driving up interest rates and making companies even more leveraged than the current record amount)

So stakeholder capitalism might sound great, but it's just really massive theft from current shareholders dressed up as social responsibility, and has many *unintended consequences*.

Second, for the last decade or so, there has been a growing movement to evaluate companies not just on their profitability, but also on several factors that are either not directly related to profitability or that actually (usually) reduce it. You may have heard of the acronym ESG, which stands for environmental, social and governance.

In recent years, assets in ESG-related funds have exploded. Some people want to feel good about themselves, and treat their investments more like charitable donations. One sees this kind of focus on loftier aspirations at the end of a long bull market when people just assume that companies always make a profit and investors never lose money. Trust me, there was no talk about ESG in the first few months of 2009. The focus then was on survival, as it will be again soon.

I do believe that corporate governance is very important. A study I once read concluded that the stock of companies with good corporate governance returns about 2.5 percentage points more on average, which, over the long term, is a huge difference. For several years, I paid a firm $5,000 per year to receive detailed information about the corporate governance of hundreds of companies. There are many (nuanced) considerations. If the wrong people with the wrong incentives are running the show with little to no oversight, the result can be another Enron.

Virtually everyone wants a clean, healthy environment. However, you can get too much of a good thing (the Law of Diminishing Returns). The problem with pursuing environmental goals is that the greener you want to be, (usually) the more “green” it's going to cost you. A company that is driven into bankruptcy due to environmental regulations or standards will produce no carbon emissions (or jobs, products, or profits).

Also, the science of anthropogenic “climate change” (the term used to be “global warming,” but “climate change” covers all of the bases) is complex, controversial and definitely not “settled.” There are many well-meaning people in the environmental movement. The problem is that it is largely driven by a political agenda that has nothing to do with the environment. The proposed solution to anthropogenic climate change is (naturally) to give more money and power to the government (which means less money for shareholders and thus lower returns).

Social criteria have the most potential to destroy shareholder value. Look, companies already have a strong financial incentive to have a good reputation in their community. They donate billions of dollars and millions of volunteer hours to charity, sponsor thousands of community events, provide scholarships, and help their communities in innumerable, often quiet ways (besides providing jobs, great products and services, and profits).

Different companies have different ways of being "socially responsible" and creating goodwill. For Starbucks, it might mean hiring baristas who are refugees, paying them $20 per hour, providing health insurance and paying for their college education. For Wendy's, it might mean supporting the adoption of orphans through the Dave Thomas Foundation. Each consumer is free to choose which companies to patronize based on their practices and values.

The problem with ESG criteria is that people in the elite 1% (Davos Man, World Improvers, The Powers That Be) will be the ones who decide what is considered "environmentally responsible," "socially just" and "good governance." If a company doesn't meet their one-size-fits-all definition of "good," then they are "bad."

The modern world is far more complex than our (relatively primitive) brains can handle, so to save time and energy, they are constantly looking for ways to simplify that complexity and ambiguity into an easily digestible form, preferably one that's binomial. For example, on social media, a person is either my Friend or not my friend; they either Like my post or don't like it. "Fact checkers" determine that a claim is either True or False. A company is either socially and environmentally responsible, or it's not. There are people out there who think they are omniscient and that their way is the only way that should be allowed. Of course, life is all nuance and shades of gray, and no one has a monopoly on the Truth.

ESG is a Trojan horse and will be a key component of stakeholder capitalism in the coming Great Reset. The big accounting firms (disclosure: I once worked for Price Waterhouse), which always have a prominent role at Davos, have been pushing ESG hard, probably because they stand to make billions from an entirely new "accounting" system and related consulting work.

Third, hundreds of companies have (rightly or wrongly) used COVID-19 as an excuse to eliminate, reduce or not increase (which, given inflation, is the same thing as a cut) their dividend. This makes their stocks less attractive to investors, so their price has to fall.

Further, it has been proposed that the corporate income tax rate be increased from 21% to 28%, with a 15% minimum tax on book income. The combined 32.34% federal and state income tax rate would be the highest in the OECD and among G7 countries, making U.S. companies uncompetitive. This would result in even less free cash flow for investors.

Additionally, thanks to artificially low interest rates (due to the Fed's currency printing and bond buying), companies have been issuing massive amounts of debt in recent years and using the proceeds to buy back stock (so that management can exercise its stock options at a good price), make (probably ill-advised) acquisitions, etc. This increases their leverage and makes their stock riskier, especially if interest rates rise and they have to refinance a huge debt pile at higher rates.

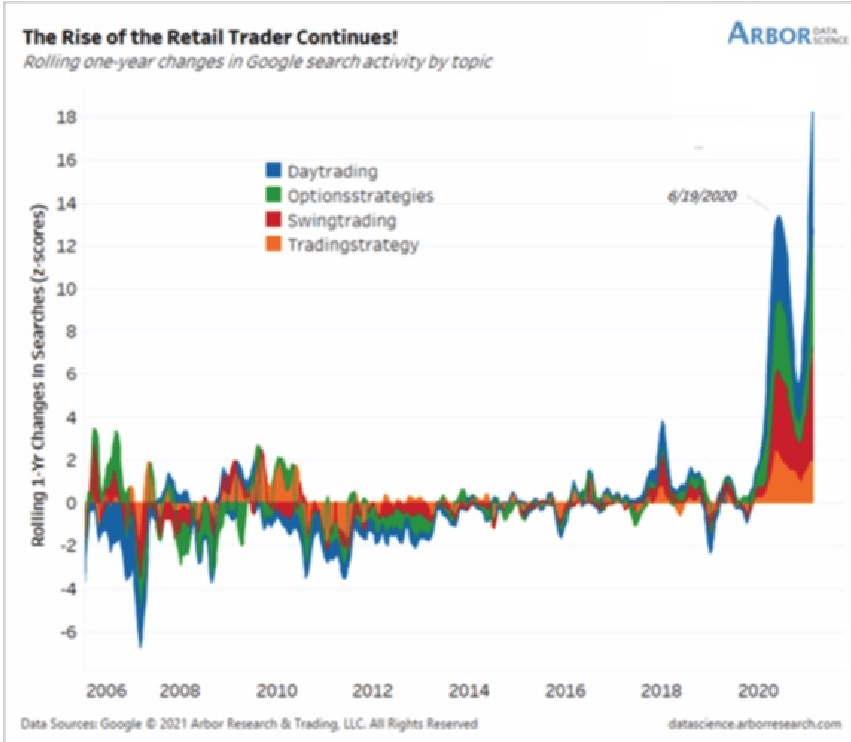
Moreover, the U.S. lost as many as 200,000 small businesses during COVID, so none of these will ever become small cap publicly traded stocks. And probably about 20% of the companies that have survived are zombies that should have failed but have been kept alive with government bailouts.

As of the beginning of the year, the U.S. stock market was the second most expensive in the world (based on a combination of price/earnings, price/cash flow, price/book value and dividend yield). Over the long term, investing in richly valued stock markets has produced low to negative returns.

Finally, as the Reddit investors recently discovered with GameStop, the game has become massively rigged against equity investors (at least in the U.S.). I'll devote an entire future issue to this.

The Spirit of the Times

Get me in!



Making money is easy! Anyone can do it. Just Google "day trading" or "options" and start putting that stimmie check to work.

Yeah, forget the traditional 60% equities/40% fixed income split, you've got to ***get with the program*** *and put 4% into a digital token that has* [*at least 4,000 competitors*]*. Who created it and where did it come from? Has it stood the test of time? It doesn't matter, it's going to the moon!*

This week an acquaintance mentioned that his wife was going to reactivate her realtor's license. This is one of my favorite anecdotal indicators. When people with little or no background in real estate want to become a realtor (or when there are lots of newspaper ads that show dozens if not hundreds of realtors), the end is near. Similarly, when realtors and builders have to move out of their house because it was foreclosed on and they're now working as a waitress, it's time to buy.

What You Should Be Doing Now

I plan to cover the why and how of these in future issues (if I haven't already), but here are some actions I recommend you take (or at least start thinking about) now:

1. Start working on a garden. Get some heirloom seeds (if they are still available) and garden supplies. It doesn't have to be a lot, maybe just some herbs and tomatoes in pots on your deck. Learn your lessons now while the stakes are still low. Find out when to plant (including how to stagger your plantings), which spots get sun and shade, how to protect your plants from animals and insects, how to water, when to harvest, how to collect seeds, etc.

   We started a small garden in our back yard when COVID began, and for months, the highlight of our day was our morning “garden tour”: walking out to it to see what had changed from the day before. It was a miracle to watch plants sprout and grow and produce food. Playing in the dirt and the sun is good for your soul.

2. Start thinking about your systems and how you could replace them in a grid down situation: water and food, energy, security, transportation, sanitation, medical, finance, etc. Start thinking about hand tools that you might need.

3. Develop a deep library of non-fiction books in paper form, especially reference and “how-to” books. A couple of months ago, I mentioned to my clients that I was accumulating books, and one wondered why. The recent banning of half a dozen Dr. Seuss books shows that *anything is possible* during a cultural revolution/Fourth Turning. Both of the dystopian movies “Children of Men” and “V for Vendetta” show a large, secret library. My survival library includes books about survival skills, medical care, plants that can be used for food or medicine, homesteading, gardening, raising livestock, preserving food, traditional skills (e.g., the Foxfire series) and self-reliance. I use the websites LibraryThing to keep track of my library and ThriftBooks to buy them (used). I highly recommend both.

4. Books to read: Guide to Investing in Gold & Silver by Michael Maloney
   Money For Nothing: How the Failure of Corporate Boards Is Ruining American Business and Costing Us Trillions by John Gillespie
   Unreported Truths About COVID-19 and Lockdowns: Parts 1-3 by Alex Berenson

Your Questions Answered

Question #1: [Paraphrasing] “What about Treasury Inflation Protected Securities (TIPS) as a hedge against inflation?" The question came with this text: "TIPS are government-backed bonds issued by the U.S. Treasury that have an inflation protection component. These are some of the safest securities in the world since they are issued by the U.S. government and are thus free from default risk. Effectively, there's no risk that the government won't be able to pay its bills. Even better, TIPS have an inflation rider, which adjusts the value of your principal along with the Consumer Price Index....if you want pure protection against both inflation and any risk of credit default, TIPS may be something to consider adding to your portfolio."

I do not recommend TIPS for two reasons. First, the claim that U.S. Treasuries don't have any default risk is not only false, it's absurd. The national debt is now over $28 trillion (and growing by at least several trillion dollars per year), and the present value of the federal government's unfunded liabilities is over $200 trillion. There is no way that this debt and liabilities can ever be paid with honest money. Therefore, the federal government will default (*de jure* or *de facto*) on its obligations, just like it did after the Revolutionary War and the Civil War, in 1933 and 1971.

Second, although interest payments on TIPS are adjusted to reflect changes in the Consumer Price Index (CPI), guess who calculates the CPI? That's right, the federal government. And for a variety of reasons (financial, political), it is in the government's interest to understate the inflation rate, and it has been doing since 1980. Therefore, although TIPS have somewhat better inflation protection than plain U.S. Treasuries, they will definitely not provide complete protection from inflation.

Question #2: [Paraphrasing] "How do you personally buy physical gold?" Here's what I do. When the price, sentiment score and Relative Strength Index for gold get low (and/or the Commitment of Traders Report indicates that Smart Money commercial producers/hedgers are buying and Dumb Money speculators are selling), I keep an eye on the price using the live chart on bullionvault.com (gold is traded globally almost 24 hours per day, except on weekends). If you set up an account with them (which you do not have to fund), you can set up price alerts and you'll be notified if the market price crosses your price.

Every time the price hits another post-election low, I buy another one ounce bar. I buy one ounce because that's the most common (and useful) weight for gold. I buy bars because they're cheaper than coins. I don't buy loose (secondary market) bars, only bars that are "in assay" (in a protective wrapper with an assay card that shows the purity, weight, serial number and name of the refiner). The bar itself should also have this information stamped on it. I don't buy anything minted by the U.S. government or with the words "United States" or "dollars" on it (which is a meaningless term and might confuse a potential buyer).

If you sort APMEX's inventory by one ounce gold bars and rounds, then by price, you get this page. Some of the products are not currently available, and others won't be available for a week or more. If you want something and it's out of stock, you can sign up to be alerted once it's back in stock. But if the gold price is good, I wouldn't let that stop you from buying.

Price is my biggest consideration (generally, the more bars you buy, the bigger the discount), but I also prefer bars that look nice. My current favorite is “Una and the Lion” by the Royal Mint. I buy one ounce at a time because as Jim Rogers says, “Prices can go far higher and far lower than you can ever imagine.” So I want to keep most of my powder dry to give me optionality if the price keeps going lower. However, there is no guarantee that the price will ever again be as low as it is now. You may want to buy more or less than one ounce each time, depending on how much you already own, how much you want to have, the size of your portfolio, and how much time you have to deal with it. If you don't have the time or interest to track the price, etc. and just want to ensure that you accumulate some gold at a decent average cost per ounce, APMEX has an automatic investment program. I pay for the $10 UPS delivery with required signature so I can track my order and it won't be left in a mailbox.

The gold bar above is money. This is currency.

Preparedness News

Retail Investors Are Long Confidence and Short Experience

People Are Starting to Believe That Stimulus Is Permanent Look at the charts.

Too Busy Frontrunning Inflation, Nobody Sees the Deflationary Tsunami

Counterfeiting: The Oldest Profession “Researchers think the counterfeiting may have been initiated by the Egyptian rulers, possibly to disguise the fact their supplies of silver widely used as a pre-coinage form of currency were dwindling.” Hmm, sounds familiar.

Ω

I would love to hear from you! I thrive on feedback from readers. If you have any comments, suggestions, insight/wisdom, or you'd like to share a link to a great article, please email me.

Generally, I don't have time to answer questions about your specific situation, but if you have a general question that I think other readers also have, let me know and I will provide an answer in a future issue.

Feel free to forward this to a friend. If you would like to subscribe (it's free!) or unsubscribe, email me with either “subscribe” or “unsubscribe” in the subject line.

Disclaimer

The content of this newsletter is intended to be and should be used for informational/educational purposes only. You should not assume that it is accurate or that following my recommendations will produce a positive result for you. You should either do your own research and analysis, or hire a qualified professional who is aware of the facts and circumstances of your individual situation.

Financial Preparedness LLC is not a registered investment advisor. I am not an attorney, accountant, doctor, nutritionist or psychologist. I am not YOUR financial planner or investment advisor, and you are not my client.

Investments carry risk, are not guaranteed, and do fluctuate in value, and you can lose your entire investment. Past performance is not indicative of future performance. You should not invest in something you don't understand, or put all of your eggs in one basket.

Before starting a new diet or exercise regimen, you should consult with a doctor, nutritionist, dietician, or personal trainer.

Copyright 2021 Financial Preparedness LLC