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

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The Game Is Rigged

Note: I am not a market technician, and it has been years since I read the books mentioned below, so I may not get every detail exactly right. But that doesn't change the gist of the story, which is that in recent years, the stock market has been a rigged game.

Historically, American stock exchanges (there were only a handful) operated like not-for-profit public utilities, matching buyers and sellers. Prices were quoted in eighths of a dollar, a vestige of Spanish silver coins that circulated in the American colonies. (To make change, the coins were cut into eight pieces--thus the terms "pieces of eight" and "two bits" meaning a quarter.) The resulting bid-ask spread of at least $0.125 per share ensured that market makers could generate sufficient revenue to cover their costs and make a living.

In 2001, the SEC began to require that all stock quotations and trades be made in cents instead of eighths of a dollar. This move to *decimalization* was to have profound unintended consequences (strange for a government policy, I know). Suddenly, market makers found that they had to find a different way to make a living.

This was probably the primary impetus for stock exchanges to become (profit-seeking) private corporations. Technology allowed trading to take place away from the trading floors of Wall Street (which largely became sets and props for channels/shows like CNBC), in massive data warehouses in places like Mahwah, NJ.

Competition spurred the creation of dozens of new exchanges known as electronic communication networks (ECNs). Some of these did not publicly display the best bid and ask offers, so became known as “dark pools.” Thus, the market became divided into “lit” and “unlit” parts.

With so many exchanges and so much at stake (because of the Network Effect), the ECNs aggressively tried to attract traders that produced the most volume to their exchange, because volume begets volume (i.e., investors want to trade where there is a lot of liquidity—where the spread between the bid and ask prices is low, and where they can quickly sell large positions without significantly moving the price).

The traders with the highest trading volume were hedge funds (because of their size and frequent trading) and high frequency traders (HFTs). HFTs use computer algorithms to place many trades often and automatically, at blinding speeds. The more profitable these high volume traders were, the more they would trade on an exchange, so the ECNs bent over backwards to cater to their needs and help maximize their profitability.

First, (for a fee) the ECNs allowed these high volume traders to colocate their trading computers in the same data warehouse as the exchange's matching engine. Speed was quickly turning trading into a winner-take-all game for at least two reasons. First, when breaking news broke, the trader that could trade on it the fastest (after, say, using a computer program to search a just-released statement from the Fed for “word clouds,” not actually having a human read it) could earn much of the returns to be had.

One of the earliest versions of this was in 1815, when Nathan Rothschild had carrier pigeons released from the battle of Waterloo to return home to London with the news of Napoleon's defeat, which information he used to trade on.

In recent years, traders have spent hundreds of millions (if not billions) of dollars doing everything from drilling holes in mountains for fiber optic cable to sending microwaves from Chicago to New York, all in an effort to shave a few nanoseconds or picoseconds (a trillionth of a second) off of their latency so they can get to the punch bowl first. Colocating your trading computer in the same building as an exchange's matching engine means they're only feet apart instead of miles apart. Every little bit matters.

Second, high speed allows a trader's computer to see a new order in another part of the market and then front run it, due to the difference in speeds at which different orders flow through the wires. It's like having a time machine, or being able to see into the (very immediate) future.

The ECNs also sell information about retail orders to their high volume customers, which love to trade against this Dumb Money since it's so profitable. So these Smart Money traders can not only see pretty much the complete order book (the list of all bid and ask offers by price and lot size), they can also see where the trade came from (e.g., a retail broker such as Charles Schwab), whether the limit price has been changed, etc.

High volume traders also have advantages that retail investors do not. For example, retail investors can only use the traditional handful of order types (market, limit, stop, stop limit), whereas high volume traders can use dozens of exotic order types that were created just for them (such as one called “hide don't slide”) that allow them to sniff, spoof, front-run and otherwise game the system.

Today, the vast majority of orders are placed by HFTs, and perhaps most of those aren't even real orders, they're just feints and probes. One analogy I read is that you're in a grocery store about to check out, and no other customers are in line. Suddenly, a handful of customers with shopping carts appear in front of you in line. Another analogy: You're in a race with other cars when suddenly the car ahead of you (which you can never pass) moves to the side and a Mack truck appears in front of you going in the opposite direction, running over you.

High volume traders can also use sub-penny pricing ($0.001), while retail investors cannot. This allows them to game the system even more.

Have you noticed how so many things are free these days? For example, if you want to use a Google or Facebook product, it's free! Likewise, if you place a stock trade at a retail brokerage, that's free, too. How awesome is that? Well, in our new system of Surveillance Capitalism, if something is free, then *you are the product*.

Trading against Dumb/Disadvantaged Money retail investors is so lucrative to the Smart/Advantaged Money hedge funds and HFTs that for about the last decade, they have been paying the exchanges to route the Dumb Money/retail orders to their dark pools so they can sniff, spoof, front run and trade against them.

This blatantly unfair practice is called “payment for order flow,” and is completely at odds with the requirement of “best execution,” which the SEC is supposed to enforce. (Like virtually every governmental regulatory agency, I'm sure the SEC has been “captured” by the industry that it supposedly regulates, thanks in part to the Revolving Door.) Payment for order flow is so profitable to the exchanges that they no longer even have to charge a commission for stock trades.

I became familiar with these unfair and abusive practices years ago when I read Flash Boys by Michael Lewis (which is being made into a movie), which is a good introduction to the subject.

I asked the brokerage firm (Fidelity) that I was using at the time as the custodian for my clients' accounts if they accepted payment for order flow. After weeks and months of waiting for an answer, I finally scheduled a call with my relationship manager to discuss the issue, but he ghosted me. Days later, Fidelity informed me that they were terminating their relationship with my firm, and I would have a month to find a new custodian and get all of my clients' accounts transferred. I lost at least one client as a result (no good deed goes unpunished). The message: *Don't ask us how we make money off of your clients because it's ugly.*

If you'd like to read further on the subject, I recommend <u>Broken Markets</u> and <u>Dark Pools</u>, which are listed below.

Is it still possible to make money investing in stocks? Absolutely. I'm in the process of selling some stocks I bought a year ago during the COVID panic that have an unrealized capital gain of as much as 178% (plus dividends received). Like playing games in a casino, you just need to be aware that the deck is stacked against you and go into it with your eyes wide open. I try to minimize being taken advantage of by minimizing trading and just collecting dividends. As always, *caveat emptor.*

Your Questions Answered

(slightly paraphrased): "Precious metals (and especially the stock of the companies that mine them) got destroyed after they peaked in 2011. It's hard not to feel like the same thing could happen again. What's different this time? What can we do to hedge? What makes gold the most "real" of money? What about other commodities or real estate? Why gold?"

There is a time and a season for everything, and you should never be permanently wed to any one asset class, especially since valuations and sentiment can become way too high. Your strategy should be to invest in different undervalued and out of favor asset classes to reduce risk and increase your wealth over time.

I think the 2012-2015 bear market in precious metals and mining shares was primarily due to (1) valuations and investor sentiment got ahead of reality (i.e., they became too high too fast) and (2) the story that the Federal Reserve started telling about how it was going to reduce or stop its currency printing and raise interest rates.

With the Fed now printing $120 billion per month (and the federal government spending like a drunken sailor) and no end in sight for its Zero Interest Rate Policy (ZIRP; there is now talk of negative interest rates), how did that story turn out? Many investors sold their gold for less than $1,100 an ounce at the end of 2015 because they believed the Fed when it said that it would tighten monetary policy in the future. In retrospect, with gold now around $1,735 an ounce, was that a good decision to believe the Fed?

Officially, Congress has given the Fed a "dual mandate" of price stability (which the Fed bizarrely thinks means that prices should increase by 2% per year) and maximum sustainable employment. Recently, the Fed appears to have imposed a third mandate on itself by saying that its currency printing and ZIRP will continue until it sees a jobs recovery that is "inclusive" across income, gender and racial lines. So basically forever, because the more it prints, the more inequality there will be.

For over a century, the Fed's job has been to enrich the elite 1% (and the government they control) by debasing the currency and lying about what they're doing and why. Its job is to obfuscate and confuse, and make counterfeiting look respectable.

Even though the dollar has lost over 95% of its value since the Fed was created (an ounce of gold cost $20 in 1913, today it costs $1,735), thanks to propaganda from the media and the government, most Americans believe that the Fed is really trying to help the economy and all Americans, so they believe what it says. The Fed has so much credibility (and investors have such a short memory) that most of the time, it doesn't even have to do what it says it will supposedly do in the future, it just has to talk about it and markets will react the way it wants them to. It refers to this dissembling as "forward guidance"; the financial media calls it "jawboning." I think that as part of a growing Great Awakening in recent years, more and more Americans are beginning to realize that the Fed is the Man Behind the Curtain.

Precious metals are a very different "investment" than the stock of the companies that mine them. Yes, mining shares can provide leverage to the price of precious metals (if they don't engage in hedging), and when all of the stars are aligned, they can produce very high returns. However, that investment thesis is actually more complicated and problematic.

First, although mining shares can provide leverage to the price of precious metals, they also provide leverage to a number of other things that don't have anything to do with the price of precious metals, including operational leverage, management skill, debt and interest rates, energy costs, base metal prices (precious metals are usually byproducts of mining base metals), etc.

Second, when I say that all of the stars have to align, the problem is that there are *a lot* of stars, including (besides the ones mentioned above) no labor problems, no environmental problems, no problems getting permits (some governments seem to drag out the process, fishing for a bribe), no problems with taxes or nationalization by the local government, no problems with locals (opposition to mining, vandalism, sabotage, kidnapping, guerrilla attacks), no operational problems (equipment breakdowns, loss of electricity), no bad weather or flooding, no problem sourcing mines for future growth, no shortage of cash and financing, etc. It seems like there is always a problem.

Perhaps the biggest problem with mining companies is that human beings are involved. Mark Twain wrote, "A gold mine is a hole in the ground with a liar standing on top." The dream of becoming rich by pulling precious metals out of the ground has lured investors since at least the time of the Mississippi Bubble in 1718-20.

Today, much of the value of an undeveloped ore body (and thus of the stock of the mining company that owns it) is based on an analysis of drilling samples that's done by an independent firm. The problem with this is the same as with the credit rating agencies rating debt in the mid-2000s: the issuer (or miner) pays the rating agency (or assaying firm) for the rating (or analysis). With so much money at stake, the potential for corruption exists. Watch the movie "Gold," which is "based on a too good to be true story."

Finally, yes, the management of mining companies are in the business of mining. But what are they mining? Based on how much and how often they award themselves stock options (which can range from the generous to the egregious) no matter how the company performs, an argument can be made that they are primarily mining the equity of the company at the expense of the shareholders. (Stock options, which dilute existing shareholders when they are exercised, are one of capitalism's worst inventions ever, especially since the holder of them has nothing at risk.)

The price of gold can be (and has been, perhaps for decades) manipulated. The vast, vast majority of "gold" that is traded in markets is not actual physical gold but "paper gold" (futures contracts). Futures contracts allow a trader to control a large notional value of a commodity with just a small amount of capital. That leverage combined with the right timing of a large market order (which is usually placed in the wee hours of the morning when nearly all of the world's markets are closed, which, due to the very low trading volume, is not a time that a profit-seeking, rational trader would place a large market order) can really move the price (especially on a relatively small market like the one for gold) and negatively affect investor sentiment.

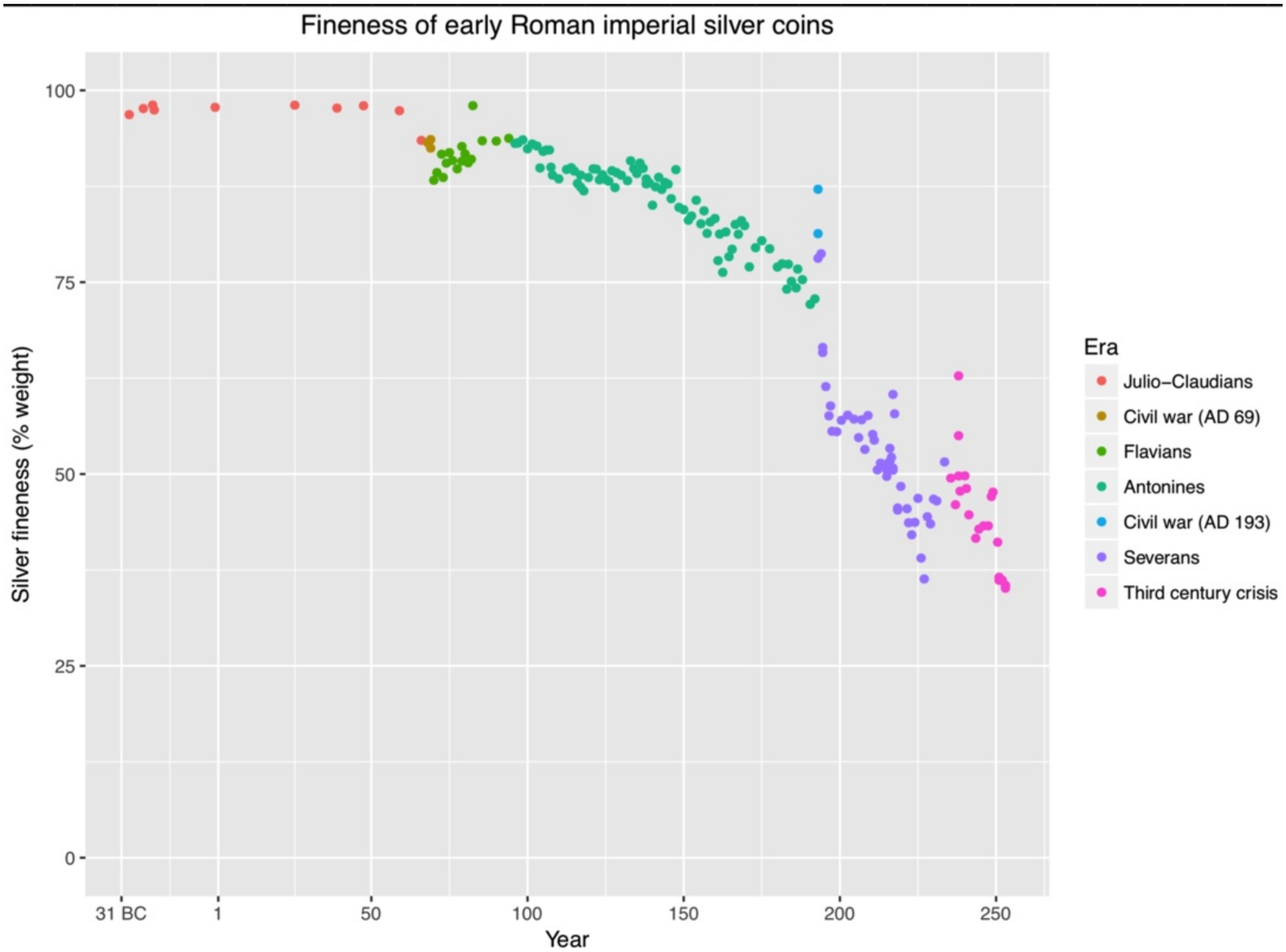
Even though the price of "paper gold" can affect the price of and sentiment for physical gold, there will always be a premium for the latter, because owning a gold futures contract (which is almost always settled in cash, not by taking delivery of actual gold) is not the same as owning physical gold. As the manipulation of the price increases and investors insist on holding physical gold, the premium between paper and physical gold will increase, as sophisticated investors who buy physical gold aren't fooled by the price of paper gold.

Central banks (and commercial banks operating under their direction) and governments can also sell or lease gold, thus depressing its price. Between the huge amount of gold the U.S. earned selling war materiel to both sides during the first half of WWI, FDR's confiscation of gold in 1933, and the shipment of much of foreign governments' gold to the U.S. for safekeeping during and after WWII, the U.S. government and Federal Reserve came to be in possession of three quarters of the world's gold. Most of this was eventually sent to foreign countries (primarily France and Switzerland) around the late 1960s when there was a "bank run" on the U.S. (until Nixon closed the gold window in 1971), but any gold that was left could have been used for sales or leases in recent years.

Interestingly, when Germany asked the U.S. for its gold back in 2013 (after the U.S. refused to allow German officials to inspect it), it was told that it would have to wait seven years to get it back! "The long timescale led to furious rumors that America had actually sold Germany's gold and needed time to gradually buy replacements." No one really knows how much gold the federal government/Fed actually has because there has never been an independent audit of it.

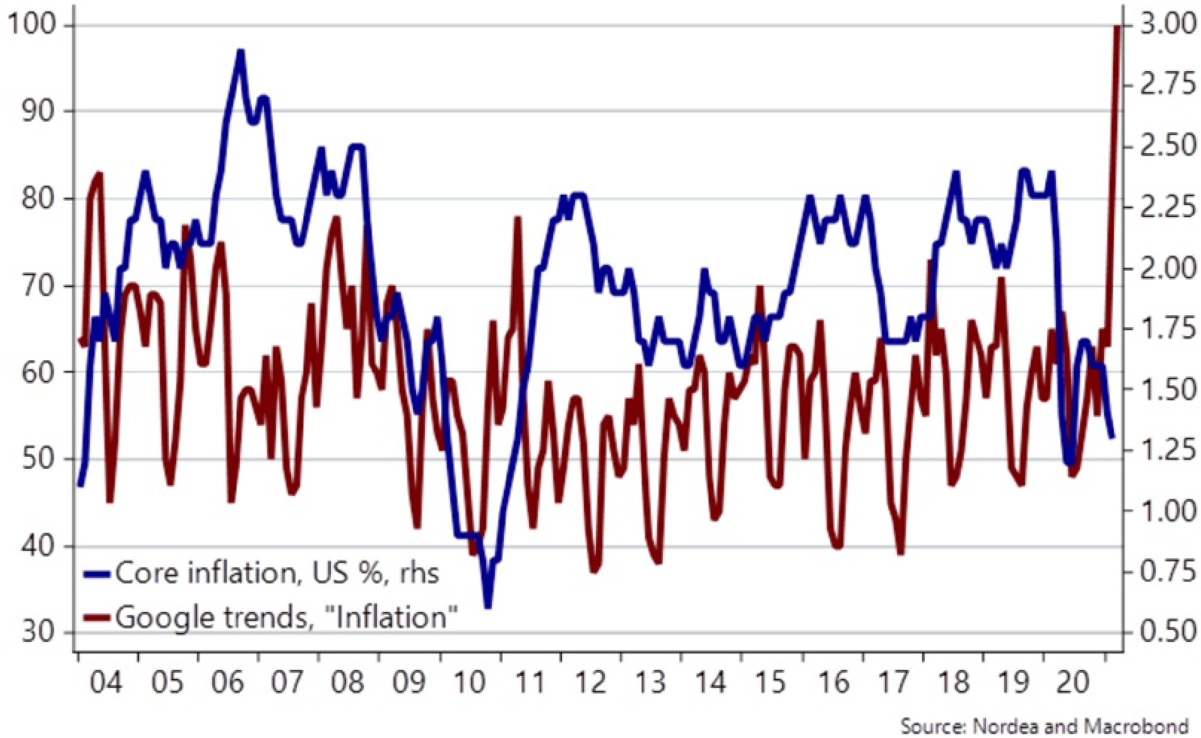
This "conspiracy theory" became a "conspiracy fact" last Fall when J.P. Morgan admitted wrongdoing and paid a fine of over $920 million (the largest ever imposed by the CFTC; of course, none of this went to the investors who were harmed by this crime) to settle a criminal investigation "alleging that the bank hosted an eight-year market manipulation conspiracy with its precious metals desk as a criminal racketeering operation." Apparently JPM was not the only bank that was involved. But this is just a cost of doing business/bribe for looking the other way in the future, as JPM makes about $1 billion per year on its precious metals business.

Governments have been stealing from their citizens by debasing their currency since at least 64 AD (Nero). It is a recurring story that is almost as old as civilization itself. Wagering that this intrinsic flaw of government and human nature will suddenly come to an end after two millennia would be very long odds indeed, especially when you consider the federal government's massive debt, unfunded liabilities and runaway spending. If something is not sustainable, then at some point it will end.



As the silver content in their coins declined, so did their empire.

This page shows the 2019 production of precious metals compared to that of global currency, while this page shows the same data for the first nine months of last year (note the chart at the bottom right that shows the growth in U.S. dollars).



Why do people suddenly want to know more about inflation?

Gold and silver have been used as money for about 5,000 years, not because a government said that they were legal tender (fiat money), but because billions of people over millennia decided that they were closest to having the properties that good money requires. Precious metals have stood the test of time better than just about anything else. Like Nassim Taleb, I have tremendous respect for things that have stood the test of time. The longer that something has been around, the longer it is likely to be around in the future. Precious metals are refreshingly authentic, Old School and eternal in a world full of fads, ephemera and fake plastic crap.

Precious metals are indestructible elements found in limited quantities in the earth's crust. They were made by nature, not by the printing press or computer of a central bank. They are dense and heavy, visually attractive, and are universally recognized, valued and accepted. In a world of unprecedented debt/leverage, unregulated and complex derivatives with a notional value in the hundreds of trillions of dollars, interconnectedness (and thus possible contagion), and who knows how much fraud and off balance sheet liabilities, *they are no one else's liability*. And in a world full of increasingly desperate governments and people that are rapidly becoming infatuated with the idea of living at the expense of others, *they are private and not easily confiscated*. They are a lifeboat in the Sea of Insanity, a time machine that can transport your wealth out of ClownWorld to hopefully a brighter future.

> *On a long enough timeframe, the survival rate of every arbitrary human folly currency drops to zero.* ~ J. Handers

What about other commodities and real estate? Generally, other commodities are too difficult to purchase for small investors, perishable, not marketable or take up too much space (or are too heavy). When the Jews fled Nazi Germany, they didn't do it with bushels of wheat or I-beams of steel.

Generally, all other things being equal, real estate has the potential to keep its value during an inflationary time. And if you know what you're doing and buy the right parcel at the right time for the right price, you can certainly do well. However, real estate has a number of disadvantages:

- property taxes
- maintenance expenses
- (If you are planning to rent it out) there is currently an eviction moratorium in place that will probably be extended indefinitely, so you may never collect any rent.
- Squatting (especially by organized, aggressive activist groups) is becoming more prevalent and could become common, especially in a Without Rule of Law (WROL) or grid down situation.
- It can be targeted by thieves, vandals or arsonists. On just a few acres I own at the very, very end of a 1-lane gravel road in a rural area (it is very hard to find and get to), locals have illegally hunted and harvested timber, and on my grandparents' adjacent property, they have used it to grow marijuana and have broken into and vandalized houses twice. Thanks in part to poverty and the opioid epidemic, theft in rural Appalachia is so rampant that I don't see how owning an uninhabited structure there could be tenable.
- Real estate is not very liquid, and selling it usually requires a realtor's commission of 6-10%.
- Real estate is "lumpy," so even if you don't need a lot of money, you would still have to sell the entire parcel to extract cash.
- If we have an economic/banking crisis, a real estate crash, high interest rates or hyperinflation (I think all are likely), almost no one will be able to secure or afford a mortgage to buy your property.
- Real estate is very visible and can easily be confiscated by a government ("land reform") or armed thugs, especially in a cultural revolution (look at what happened to the farmers in Zimbabwe and South Africa) or a WROL situation.

How to hedge? First, don't put all of your eggs in one basket. You want to be diversified and have options. Just like anything, precious metals have some disadvantages. They don't generate any cash flow. They can be stolen or damaged in a fire. The government could ban their private ownership again (though in 1933, only about 22% of the gold was turned in, and apparently no one was prosecuted; it was only a presidential executive order, not a law). They may be a little tricky to sell. Personally, I actually have more of my portfolio in cash than I have in precious metals (physical and ETFs), though if the price drops again, I'd probably buy some more.

Second, don't buy your entire position all at once. Ease into it over time, perhaps via dollar cost averaging. Prices can always go much lower than you could ever imagine.

Further, I would stay away from mining shares (except perhaps a small speculative position) and the vast majority of precious metal ETFs (their ambiguous prospectuses don't actually require them to have physical metal).

Don't store your metal in a bank safe deposit box (where it may not be available to you when you need it, and where it can be confiscated by the government) or in a single hiding place. Experienced burglars know to look in your freezer, books, toilet tank, fake cans, etc. I'll talk more about hiding places in a future issue.

Buy other "hard assets" that you can use or barter: food, water procurement and treatment supplies, medical supplies, cleaning supplies, pet supplies, clothing, "how to" and reference books, bicycles, seeds and gardening supplies, tools and weapons, hunting and fishing gear, non-precious metals (lead), etc.

Keep plenty of money in physical cash and don't max out your credit cards (so you can charge a lot to them quickly if you need to).

Don't have all of your money and wealth in the financial system. In recent years, I have gradually been moving mine out, especially out of traditional IRAs/401(k)s.

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. If you bank with a commercial bank, switch to a credit union instead. Credit unions are member-owned, not-for-profit financial institutions, so unlike banks, they generally don't take nearly as much risk trying to earn a profit for shareholders and a high stock price for management's compensation, they don't mess around with derivatives, they're not wards of the state that constantly have to be bailed out, and they are not subject to the Community Reinvestment Act (see Architects of Ruin below and also The Great Devaluation, which I'll review in an upcoming issue). Also, when was the last time you heard about a credit union being fined by regulators for deceptive/abusive practices? Big banks like Wells Fargo often have to pay huge fines for abusing their customers.

2. If you are over 50 and haven't had a colonoscopy yet, schedule one now. It's easy! Colon cancer is one of the most preventable diseases there is. A friend of ours has a (59 year old) pilates instructor who just found out she has Stage IV colon cancer (apparently she had never been screened).

3. Books to read: Flash Boys by Michael Lewis

   The Big Short: Inside the Doomsday Machine by Michael Lewis. This tells the story of the housing bubble. I think it's helpful to read about the similarities between that and today's environment. The book has been made into a movie, which I also recommend.

Broken Markets: How High Frequency Trading and Predatory Practices on Wall Street Are Destroying Investor Confidence and Your Portfolio by Sal Arnuk

Dark Pools: The Rise of the Machine Traders and the Rigging of the U.S. Stock Market by Scott Patterson

A Short History of Financial Euphoria by John Kenneth Galbraith. The author--a well-known liberal in his day—is critical of the Friedmanite/Chicago School Efficient Market Hypothesis (I agree that its assumptions are not realistic). Unsurprisingly, he can't seem to bring himself to say the world "gold," substituting "specie" or "hard coin" instead. The new ground he covers—which is the most interesting part of the book--is about more recent manias/crashes. He identifies several recurring themes, including (1) the development of some new situation, technology or financial innovation that gives rise to a story that gullible investors fall for, (2) the use of leverage to boost returns, (3) the conclusion that quick and large capital gains are the result of the investor's own shrewdness, (4) the validation of and participation in the mania by the leading experts of the day, and (5) the subsequent anger and search for a scapegoat after the bubble bursts, with no self-reflection about investors' own greed and gullibility.

The Great Crash of 1929 by John Kenneth Galbraith

Architects of Ruin by Peter Schweizer. This is a fascinating and illuminating book. I have followed politics closely since I was a teenager and have a bachelor's degree in the subject, but I was amazed by how little I knew about how much political activists and politicians were responsible for the housing crisis. Since I've never been a big bond investor, I had never really heard of subprime mortgages until the financial media started talking about them around early 2008. But by that point, housing activists, community organizers, professional shakedown artists and politicians had been increasingly (and stunningly) successful at cajoling, threatening and coercing banks to lend *hundreds of billions* of dollars to borrowers who had terrible credit and couldn't afford the mortgages. And they had been doing it for *over 30 years* (the Community Reinvestment Act became law in 1977). I was amazed by their financial imprudence and reckless desire to saddle poor people with debt they couldn't afford (or their wanton disregard for lenders' capital and banks' solvency—it had to be one or the other), naiveté about human nature, shameless extortion rackets, brazen corruption and unbelievable gall and projection. What's ironic is that after all of their decades of activism and coercion, today fewer poor people are homeowners, poor neighborhoods have been blighted, and many poor people never want to be a homeowner again. Five stars and a Must Read.

Preparedness News

Biggest Federal Tax Hike Since 1993

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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.

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