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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What Not To Invest In

The fastest and easiest way to find good investments and thus increase your odds of having a good investment experience is knowing what ***not*** to invest in. After 32 years of reading, thinking and learning about investing, here's my list of what not to invest in:

U.S. Treasury bonds – The federal government is hopelessly broke and will never be able to pay off the $30.5 trillion that it *currently* owes (not including the additional trillions of dollars it piles on every year), much less the $170 trillion of unfunded liabilities (for Social Security, Medicare, federal pensions, etc.) that it has promised to pay in future decades.

To add insult to injury, thanks to the Fed's financial repression (i.e., buying massive amounts of Treasuries using "money" created out of thin air), the interest rate on this debt is laughably low. You'd be a fool to invest in such a thing. Sure, the government has the power to collect taxes to pay the interest and principal on its debt, but you can't get blood out of a turnip. A government with the power to collect massive amounts of tax also has the power to confiscate (either *de facto* or *de jure*) your IRA.

Bonds – Sure, in a world where interest rates were set by the market (based on supply and demand) and the currency kept its value, I'd be willing to lend lots of money to corporations that were profitable and financially strong. But as far as I know, all bonds around the world are denominated in a fiat currency, and as Voltaire observed in the 1700s, eventually, all fiat currency reverts to its intrinsic value: zero. At least one Founding Father (Thomas Jefferson) lost a fortune when [the Continental became worthless], which is why the Constitution requires that [no state shall make anything but gold and silver legal tender]. Tragically and inexplicably, the Constitution did not require this of the federal government, which has to be one of the biggest blunders in history. The linked article mentions that during the Revolutionary War, the British were counterfeiting the Continental on a large scale. I know the Nazis did the same thing to the currencies of its enemies during WWII. So counterfeiting a currency is an act of war, yet *we've been doing this to ourselves (via the Fed) for over 100 years!* Is it any wonder we're heading towards collapse?

Mutual Funds – Their expense ratio is almost always way too high, you have no control over who manages the fund or what the fund may own (unless it's specified by the fund), you may not know what you own (unless it's published in real time on their website), there is no intra-day liquidity, you don't know what price you'll receive when you buy or sell shares, you can't use limit orders, and if you hold the fund in a taxable account, you'll receive capital gains distributions on which you'll have to pay income tax even if you haven't sold any of your shares or those gains were accrued before you became a shareholder.

Mutual funds also suffer from the problem of hot money: Invariably, investors send them a lot of new money to invest when sentiment and valuations are high, but sell their shares when sentiment and valuations are low, forcing the fund (unless it has plenty of cash) to buy high and sell low.

Index Funds – Index funds almost always own at least 500 securities, but I don't want to own everything, I only want to own the most attractive 1% of securities. Sure, everyone should be diversified to minimize unsystematic risk (for which you do not get compensated for accepting), but that can be achieved by as owning as few as 20 securities.

The vast majority of index funds are weighted by market capitalization, so the bigger the company and the more richly valued it is, the more of it the index fund owns. This is the *opposite* of what you should invest in if you want to increase your expected return (small cap value stocks).

This is how many if not most investors are investing today, but as a contrarian, I don't want to be doing the same thing as the masses, I want to be doing the opposite, or at least something different. As Doug Casey says, when it comes to investing, you're either a contrarian or you're roadkill.

One of the biggest problems of index funds is that they create a space where corporate executives can engage in bad behavior (i.e., actions that are contrary to the interests of shareholders) and still get away with it. For example, if you're the CEO (or even worse, the CEO/Chairman) of a corporation with a market cap of over $5 billion, you know that tons of investors are going to own your stock via an S&P 500 index fund, including in their 401(k). They don't have the time, money or energy to keep up with what you're doing, especially since it's such a small percentage of their portfolio.

What's that, you say? Vangaurd, Blackrock and State Street are managing those index funds for you and ensuring that the companies in them are being managed to maximize shareholder value? Think again! All three are proponents of “stakeholder capitalism,” which moves other “stakeholders” ahead of shareholders on a corporation's list of priorities. Shareholders aren't even mentioned until priority #5, and the verbiage about “maximizing shareholder value” has been eliminated.

Finally, as the book The Fearful Rise of Markets details, during a financial crisis, the correlation coefficient of almost everything moves toward +1.0 (perfectly positively correlated), so almost everything declines by about the same amount at the same time. This trend has been exacerbated (if not caused) by the increasing use of index funds, which causes investors to behave much more like a herd.

Ironically, the more that investors use index funds, the more they should underperform, since there are fewer investors actually looking for abnormal profit opportunities, thus leaving more such opportunities available. Index funds are one of those ideas from academic finance that “seemed like a good idea at the time,” but I predict that they will go down in history as having greatly contributed to the largest financial crisis in history. All of these factors combined are a perfect setup for massively low (negative) returns and investor disappointment.

Most ETFs – ETFs suffer from many of the same problems as index funds, but at least they have intraday liquidity and you can use limit orders with them, though their expense ratio can be on the high side. I own some single-country ETFs that I bought to obtain exposure to the cheapest stock markets in the world. The problem is that they are mostly invested in the largest companies in those countries, which are primarily utilities, banks (which are often loaded with the sovereign debt of their government) and other industries that have a low expected return. About half of the ETFs I own are managed by iShares, which is owned by Blackrock, which is run by Larry Fink, one of the biggest proponents of “stakeholder capitalism” in the world. When I bought them, I was not aware of his views at the time, so now I plan to sell them when I can get a good price for them.

Annuities – These are investment products sold by life insurance companies that help them hedge the risk of writing a lot of life insurance policies; an annuity is the opposite of a life insurance policy. The payments from an annuity can be either fixed or variable. If you receive fixed payments, those will be destroyed by high inflation. Payments from an annuity are supposedly “guaranteed” by the insurance company, but all companies (including insurance companies) eventually go bankrupt. And the vast majority of insurance companies' assets consist of bonds (including U.S. Treasuries), the value of which can be destroyed by default and rising interest rates and inflation.

Insurance companies – See paragraph above. In a world of high inflation, why would anyone buy an insurance product that paid a fixed dollar amount, such as a life insurance policy or a fixed annuity? These companies are toast, but investors are probably only just now beginning to realize that.

Banks – The vast majority of banks' assets consist of loans (to highly indebted borrowers) that are denominated in fiat currencies, and bond portfolios (including plenty of sovereign debt). These days, the big ones are often black box hedge funds stuffed full of exotic derivatives that are too complex for anyone to figure out what their exposures are. No one can predict how these contracts will interact with each other during the next financial crisis—a perfect example of "emergent properties" produced by a complex system.

Banks are also highly regulated and basically have to do whatever the federal government tells them to do. Too big to fail and too big to jail, they're zombie companies that are just a margin call or phase transition away from complete collapse.

Utilities – Sleepy, highly regulated and dependent on affordable credit. When push comes to shove during a period of high inflation and interest rates, regulators will shaft shareholders to keep rates down.

Drug companies – The pharmaceutical industry has a long history of deception and fraud that has cost the health and lives of millions of people. Prescription drugs are the third leading cause of death in the U.S. and Europe. There are a number of books about this, but you will never see an investigation by the media or the federal government since the industry spends more money on advertising and campaign contributions (not to mention payments to doctors) than any other industry. I invest in tobacco companies (which killed my grandfather and an uncle), but for decades now there has been a prominent health warning on every pack. At least tobacco companies are honest about it; they don't claim that using their products will improve your health.

Another problem with investing in drug companies is that your return depends to a large extent on the outcome of trials and final approval by the FDA, and even then, the patent expires eventually. All of that is too uncertain and too much to keep track of.

Defense contractors – There are several problems with investing in this industry. First, revenue and profits are determined primarily by military and political decisions, which are too unpredictable. Second, there is only one customer (the federal government), and it's bankrupt. Third, supporting the industry facilitates war (the health of the State), and its products invariably kill thousands of innocent people, including children. Pass.

Companies in basket case countries – I don't invest in countries that don't respect the rule of law and private property rights, and have basic investor protections. I don't want the companies I own to have to pay bribes to corrupt government officials, or have their assets confiscated by a kleptocracy. Currently I avoid Russia, China, almost all of Africa, etc.

Stocks that don't pay a dividend or cut their dividend in recent years – Generally, these stocks should underperform stocks that have a long history of increasing their dividends every year. I also generally avoid U.S. stocks that have not increased their dividend within the last year.

Companies in which insiders own very little of the common stock – High insider ownership helps eliminate the conflict of interest problem by aligning the interests of management with those of shareholders. If insiders aren't willing to own the company, then why should my clients and I?

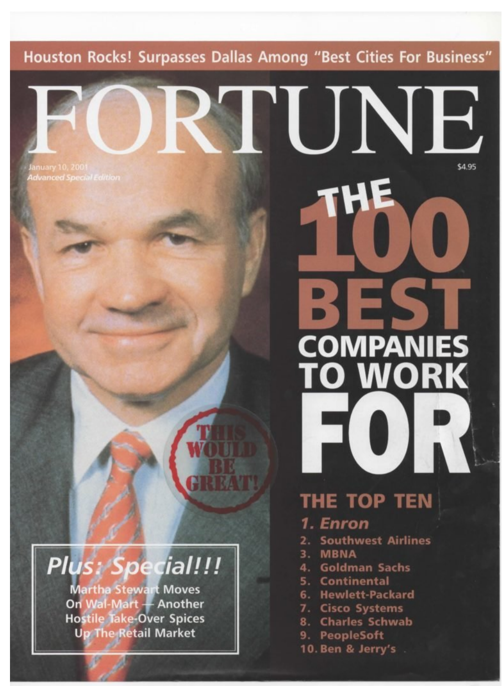
Companies that signed the Business Roundtable declaration that redefined the purpose of a corporation away from maximizing shareholder value – If these CEOs say that shareholders are now only their fifth priority, ahead of other “stakeholders,” I'm going to take them at their word. Sayonara!

Companies that spend a lot of time, energy and money engaging in politics, especially those that then virtue signal about it – These companies have obviously taken their eye off the ball and are not spending their time trying to maximize shareholder value. I'm a spreadsheet poet who deals in numbers, so like the Chinese government, I've developed a “social credit score,” but for companies so I can quantify this problem (as it's not black and white). The worst offenders include Apple, Coca-Cola, Microsoft, IBM, AT&T, Walmart, Target and Starbucks. I'm sure Google and Facebook are in there, too, but I don't even bother to track them.

By the way, I've noticed that the companies that fall in the two paragraphs above also have some of the lowest insider ownership of the ~1,800 stocks I track. Coincidence? I don't think so. It's easy to spend Other People's Money to make yourself look like you're saving humanity.

Bitcoin – I still don't know who started this or why. I support the idea of decentralized finance over government fiat currencies, so I'm not opposed to a cryptocurrency that's actually backed by something of value (such as precious metals), but there needs to be better protection from hackers and [fraud](#). These have not stood the test of time.

Business Development Companies – I think these are basically Ponzi schemes that haven't collapsed yet.



Other reasons – This includes a low median 10-year return on invested capital, a dividend yield below 3%, possible Value Traps (stocks that are cheap for a reason), not enough data, not enough trading volume, not enough history, public-private companies, etc.

If you can clear away the thousands of securities using the screens above, it makes it much easier to find good investments. Then you just need to wait until they're available for a good price, and have the courage to “catch a falling knife.”

Don't have time to do all of that fundamental analysis? Here are some quick rules of thumb. Avoid anything that is an IPO, recommended by Goldman Sachs or Jim Cramer, is featured on a magazine cover, whose CEO belongs to the Business Roundtable or attends Davos, is building a new headquarters, your friends are bragging about owning, is the most searched for stock, or is in a country where the world's tallest skyscraper is under construction.

What You Should Be Doing Now

Gold is close to a one-year low, silver is at a two-year low, and platinum was recently near a two-year low. The Optimism Index for these metals is 31, 23 and 21, respectively, which is bullish. Silver and platinum are especially attractive.

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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.

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