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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Don't Be Left Holding the Bag

For decades, the financial media has told investors that they should earn a long-term average annual return of about 11% from investing in stocks, and about 13% from investing in small cap stocks (which tend to be value-priced). I track about 1,900 dividend-paying stocks from all over the world using a massive and powerful spreadsheet. I organize them primarily by their 10-year median return on invested capital (ROIC). Two other metrics I track are their lowest and highest annual ROIC during the last decade, which gives me a good idea of how much downside risk and upside potential they have. I also track how quickly the ROIC has grown or declined during the last decade.

Ten-year median ROIC is the first screen I use, because it quickly tells me whether the company is a good business or not. ROIC tells you the likely return from each additional dollar invested in the business. As an equity investor, generally I want to see a 10-year median ROIC of at least 11%. However, there may be times when I'm willing to accept a lower amount. For example, let's take a look at Flowers Foods, which has a 10-year median ROIC of 8.7%, a 10-year low ROIC of 7.3% (which is very good), a current dividend yield of 3.4%, and has increased its dividend every year for 21 years, growing it at an average annual rate of 8.2% over the last decade. Although it's currently not attractive to me due to its valuation and financial strength, if acquired at a good price, it could play a role as a dividend-gushing Steady Eddie in a portfolio.

Nevertheless, in general, the lower a stock's 10-year median ROIC is, the more I want to avoid it. What I've noticed is that at least half of the ~1,900 stocks I track have a 10-year median ROIC of less than 8%. And remember, all of these stocks are financially strong enough to pay a dividend, so I suspect the median ROIC stocks that don't pay a dividend is even worse. Also, I don't track highly regulated companies such as utilities and banks, so they're not dragging down these results.

Generally, these low-ROIC stocks belong to large, bloated companies that are in sleepy or declining industries, make big, complex products (such as airplanes or cars) or receive a lot of their revenue from government contracts. It seems that most of them are located overseas, usually in countries that have high taxes and regulations and not much of a work ethic, such as France and Germany. I'm not saying you can't make money by investing in, say, a French car maker, but all of the stars would have to be aligned, especially sentiment and valuation.

So who invests in these low-return companies? Well, if you own a stock index fund or exchange-traded fund, you do. The received wisdom is that investors should invest in index funds because “you can't beat the market,” “market timing doesn't work,” and index funds provide broad diversification with a (usually) low expense ratio.

This assumes you can't pay attention to valuation and sentiment, and you can't tilt your portfolio towards small cap value stocks (which have a long-term average annual return of about 14%). Also, the Law of Diminishing Returns also applies to diversification (i.e., you can get too much of a good thing). With a portfolio of only 20 to 30 stocks (that are not all in the same industry or country) you can virtually eliminate unsystematic risk (which you don't get compensated for taking), leaving only systematic risk (which you have to bear and for which you do get compensated for taking, at least eventually). Finally, other than a $5 commission for buying a stock, what's the expense ratio of a portfolio of individual stocks? Zero.

So why does the financial media, Wall Street, and professional investors such as Warren Buffett recommend that individual investors invest in index funds (or ETFs)? Because they need Bag Holders. They need Dumb Money that will be willing to buy whatever they have to sell (or vice versa) at any time, regardless of valuation or sentiment.

Stock investors are the ultimate potential bag holders, because they get whatever profit (or loss) is left over after all of a company's suppliers, employees, and bondholders have been paid, and after the government has extracted its pound of flesh. Not only is the capital provided by equity investors scarce and therefore precious, they stand to lose their entire investment, especially since bondholders would be paid off first. For these reasons, the purpose of a corporation should be to maximize shareholder value, as economist Milton Friedman advocated in the 1970s.

In a world where the ruling elite is running out of assets to plunder, in recent years they have targeted the wealth of mom and pop equity investors. In 2019, 181 CEOs of some of America's largest corporations (the vast majority of which have a low ROIC) declared that creating value for shareholders would now be their fifth priority. Huge asset managers such as BlackRock and State Street openly talk about how they are "mobilizing" the many trillions of dollars under their supervision to finance the hare-brained initiatives of The Great Reset, which have nothing to do with creating shareholder value (in fact, they boast that "You'll own nothing and be happy"). And Europe is increasingly saddling its corporations with crushing and idiotic ESG mandates and regulations.

These days, as an equity investor, your first question before making an investment should be, "Will I be left holding the bag?" Yes, it's still possible to make money investing in equities, but a lot of powerful people have plans for your capital that involve adding to their pile (while making them look like humanity's savior). So you need to be aware of that going in. And finally, you need to ensure that a significant amount of your wealth is in private assets that cannot easily be plundered (e.g., water, food, precious metals, medical supplies, tools, books, knowledge, skills, health, fitness and relationships).

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