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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Small, Continuous Improvements

I ran into a friend this week who asked me if I thought the U.S. economy is going to tank over the next year. (Yes.) He then asked if he should sell his stocks and put all of his portfolio into CDs.

I never get questions like this until people start to become afraid. When fear shuts down the critical thinking function of your brain's prefrontal cortex, your body goes into Fight or Flight mode, which actually has a third option, which is Freeze. There isn't really a way for one to fight back against a declining market, which leaves Freeze (e.g., you don't look at your portfolio or open your statements for months at a time) or Flight (e.g., sell everything and go to cash just to stop the bleeding). During the Great Financial Crisis in 2008, people who I never heard from called me out of the blue, panicked, to ask if they should sell everything (as if they were my client).

First of all, you need to understand that portfolio management and investment research is a full-time job, not something that you only pay attention to after you've suffered large losses and have become afraid. Yes, I understand that virtually all of you have a day job (or are busy enjoying your retirement), a family, other interests, etc. and lack the necessary knowledge, experience and access to information. As a result, many of you have outsourced that job to an investment company such as Vanguard, and you probably invest in one or more of their index funds. You assume that Vanguard is “managing” these investments and looking out for dangers.

Nothing could be further from the truth. Even if you ignore the ESG-driven management practices that these investment companies have been pursuing in recent years (which reduce your returns and increase your risk, contrary to their legal fiduciary duty to you), if you invest in index funds, there is no captain at the wheel of the ship (to use Vanguard's nautical imagery). It's like you get on the Titanic II, which sails full speed ahead to its destination without ever changing course, no matter how many iceberg fields it encounters.

In fact, because nearly all index funds are weighted by market capitalization, the riskier the waters, the faster the ship goes (i.e., the larger a stock's market cap due to higher valuations, the more stock of that company the index fund buys, at elevated prices). Investors in large tech stocks are learning that valuations can compress as well as expand, with a $1 trillion loss in just the last two weeks. Some of them have heard the hull of their portfolio being ripped open or noticed the cold ocean water flooding their floor and have gone to the wheelhouse of the ship to tell the captain, only to discover that there is no crew. The ship is on auto-pilot, and is always fully invested. Full speed ahead. A human captain would increase the price of your ticket, after all.

Second, in order to have a successful investment experience, you have to retrain your brain so that you become fearful when valuations and investor sentiment are high (and everything is going great), and greedy when valuations and sentiment are low (and there is blood in the street). Recency Bias usually prevents this from happening. Financial markets are mean reverting over time; nothing ever grows to the moon. You don't earn investment returns by cheering on your winners and admiring your large, unrealized capital gains. You earn returns by buying assets that no one else wants to own, when it makes you sick to your stomach to do so. These are hard and lonely trades that you won't be able to brag about at a cocktail party.

Further, you want to avoid making sudden, radical changes to your portfolio that turn it into a monoculture. Usually when this happens, the investor sells at or near the bottom after experiencing large losses, just to stop the bleeding. There is no analysis of valuations, sentiment or expected returns. It's an act of capitulation, and it almost always happens at the worst possible time. You have to remove your emotions from the investment decision-making process and think at a higher, more logical level. Instead of focusing on your recent losses, you have to focus on your potential future gains given valuations and sentiment.

You also want to avoid huge, all-or-nothing trades that leave your portfolio invested in just one asset. First, this increases your risk (and the volatility of your portfolio) by dramatically reducing your portfolio's diversification. Second, it eliminates your *optionality* (which is precious), especially if you have no cash or portfolio income. You always want to have plenty of room to maneuver and take advantage of any opportunities that come along. Putting your money into illiquid investments such as CDs also restricts your freedom of maneuver.

As you manage your portfolio, you want to think of yourself as a patient sniper on a battlefield. Every day there are a few small potential targets of opportunity that present themselves that you can take advantage of. Making a sudden, large, all-or-nothing change to your portfolio is like dropping a nuclear bomb.

Instead of making large, fear-driven trades using crude, unwieldy tools such as an index fund that owns hundreds of securities, you want to make small, continuous improvements, as if you were pruning a bonsai tree. This provides you with *time diversification*, which reduces the risk that you'll make a bad decision at the wrong time.

Finally, never believe that you have *the* solution, or that you know what's going to happen. As an investor, one of the qualities you want to cultivate is *humility*. Always ask yourself, "What if I'm wrong?" or "What could go wrong that would cause me to lose money?" Be open to (and even welcome) information that seems to refute your thesis. Instead of dreaming about large gains, first focus on risk management. Try to adhere to the financial Hippocratic Oath, which is "First, don't lose any money."

In closing, as I've been telling my clients since 2009, due primarily to unprecedented debt, moral hazard and complexity, the next financial crisis will be not only the worst of our lifetime but the worst in human history. The years ahead will be primarily about capital preservation instead of earning say the long-term average expected return from stocks. And don't think that if you simply park your portfolio in a "safe" investment such as cash, you won't lose any wealth; that's an example of the Money Illusion. People who did that in places like Weimar Germany, Zimbabwe or Venezuela were wiped out.

Recent events in the Middle East are a good reminder that we live in a dangerous world. Almost every day I am shocked not only by the headlines, but by the pace of change. It feels like we are swirling around the bathtub drain at a faster and faster rate. If you want to preserve your wealth in the months and years ahead, you will need to be *agile* and *swift*. You will need to be able to predict how macro events will turn out. For example, you already know how gorging on debt will end, don't you? It's just too terrifying for your brain to contemplate.

I've been investing since 1990, and I've never seen such a perilous environment, not even close. Just when I think that things couldn't get worse, something new comes along (e.g., a cultural revolution, a pandemic, a mass die-off, crime and drug epidemics, the Great Reset, ESG investing, rigged elections, war in Ukraine and Israel, skyrocketing inflation and interest rates, etc.). I'm reminded of this quote by Henry David Thoreau:

> *In the midst of this chopping sea of civilized life, such are the clouds and storms and quicksands and thousand-and-one items to be allowed for, that a man has to live, if he would not founder and go to the bottom and not make his port at all, by dead reckoning, and he must be a great calculator indeed who succeeds. Simplify, simplify.*

News You Can Use

Six Predictions from Last Week's Horrific Treasury Report

Panic Buying of Ammo

Happenings Await by James Howard Kunstler. When I grow up, I want to be able to write like him.

Recommended

The Big Short I believe this will leave Netflix on Nov. 1. One quibble: The movie says "they blamed immigrants and poor people" for the housing bubble and the financial crash. Uh, no.

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Recommended Books
(I receive a commission if you buy a book via this link.)

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