# 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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## Stock Weightings

In a field artillery battalion, there's a small but important element: the battalion fire direction center. Run by a captain and just a few other soldiers, one of its primary responsibilities is to decide how many howitzers and rounds to use to attack a target. This could range anywhere from one round from a platoon (four howitzers in a heavy artillery battalion) to many rounds from the entire battalion (24 howitzers). This is a very important decision.

In the battle for investment returns, you have to make an identical decision for each "target." Well, you don't *have* to. You could be like the vast majority of U.S. investors today and use a market capitalization-weighted index fund (or a similar passively managed strategy), in which case the weighting of each stock would be based on its market cap (stock price x number of shares). But as Rush sings in the song "Freewill," "If you choose not to decide, you still have made a choice."

Now if you were creating the first real index fund in 1976, weighting each stock by market cap would be reasonable. Back then, virtually all investors were engaged in price discovery, which would provide the most support for the theoretical basis for index funds. Today, the vast majority of investors are *not* engaged in price discovery; they passively accept whatever prices Mr. Market quotes them each day, no matter how irrational or ridiculous they may be. This has resulted in the current unprecedented (and dangerous) situation where a mere six stocks comprise 30.6% of the S&P 500 index. That's some diversification!

Ironically, all of these passive investors who are trying to coast—like a swan flying in a V formation--on the (theoretical) implications of the Efficient Market Hypothesis have made the market more *inefficient* than ever, resulting in extraordinary opportunities for active investors such as myself. Just "coasting" is not how the investment world works; if you want to remain aloft, you have to flap your wings at some point. So if you're *not* my client, I encourage you to keep investing in index funds, as it makes it easier for me to find money lying on the sidewalk, waiting to be picked up.

The first computer spreadsheet was invented in 1978, about two years *after* the first market cap-weighted index fund. This would have made it easier to weight an index fund using more appropriate and nuanced metrics (and ones that would not result in their likely imminent self-demolition), but the die had already been cast.

Market cap weightings also solve the problem of where enormous index funds can invest their trillions of dollars. They can't take meaningful (for the fund) positions in smaller companies because (1) even if they didn't drive the price away from them due to market impact, they would end up owning nearly all of the company, and (2) it would be such a small percentage of the fund that it wouldn't move the needle. I don't need to find a home for many billions of dollars, so can take a micro-sized position in companies.

Large funds are like huge cruise ships: They can dock only in ports that are deep enough and go under bridges that are high enough. By comparison, I'm in a Jon boat, so I can get up in the shallow water and under the cypress trees where the large bass are and where there is much less competition.

Since I'm a spreadsheet poet, I created a (dynamic) formula that more appropriately weights each stock position in a client's portfolio. I start with the premise that each position must be meaningful, which is one of the Zurich Axioms. So each stock has a minimum weight of 0.5%. The confidence to initiate and hold such a position comes from composite scores I use for each stock's value (a proprietary formula that penalizes Possible Value Traps), financial strength (5 metrics), profitability (7 metrics) and growth (4 metrics). Combining these scores produces an overall score for each stock, which changes over time.

But these metrics (in my opinion) don't capture a lot of vital information, including insider ownership, percentage of shares sold short, investor sentiment, dividend safety, and the extent to which management is toeing the ESG line (i.e., how much have they turned their company into a *de facto* social justice nonprofit?).

There are two problems here. First, often much of this data is not available (especially for international stocks). Second, the data is in different forms and scales, which makes it virtually impossible to combine into a comprehensive score. So I have to interpret this data manually (and visually, with the help of conditional formatting of spreadsheet cells), which makes it more art and less science.

But the fact that this additional data is even available gives me more confidence in my judgements, as it allows me to potentially rule out certain risks (e.g., if I know that insiders own a large percentage of the company, then I know their interests are aligned with those of investors). Consequently, the availability of this data will increase my "data confidence," resulting in a higher target weighting for the stock.

So I start with a minimum weighting of 0.5% from the composite stock score above. If I have data about insider ownership, I add 0.1%. Data about the percentage of shares sold short by short sellers adds another 0.1%. If I have data about investor sentiment for that stock, I add another 0.1%; if not, I use the stock's home country sentiment score, which adds 0.05%. I have access to dividend safety scores from two different vendors (and I'm experimenting with a dividend consistency score), so if I have a score from both, I add another 0.1%, if just one, then 0.05%. Finally, my ESG score for that company adds another 0.1%. So if I have all of that data, the target weighting will be 1%.

To get my final target weighting, I multiply the target weighting based on available data (0.5% to 1%) by the stock's composite score based on fundamental data (value, financial strength, profitability and growth). Is this perfect? No, but I think it's far more appropriate than weighting my market capitalization. I'm always thinking of how I could improve my system and make it less of an art and more of a science.

Since "Securities prices can go far higher and far lower than you can ever imagine," as Jim Rogers says, and I'm a patient value investor, I scale into a position by dividing my target weighting by two and using that as my initial investment amount.

On each client's portfolio page, I compare the target weighting for each stock to its actual weighting, and a formula tells me the dollar amount that is over or under the target weighting. As a stock's price and underlying fundamentals change, its target weighting changes as well.

The loss of over 6% in Big Tech stocks on Wednesday is a good reminder that when you live by the Concentration sword, you can die by the same sword.

## News You Can Use

Global Computer Collapse Is a Chilling Look at What's to Come

Credit Card Delinquency Rates Hit Worst Level Since 2012

Homebuyer Confidence at Record Low

Tractor Supply Nukes DEI

Tucker Interviews Thomas Massie  Fast forward to the start point at 9:00.

[Tucker Interviews Glenn Greenwald]

[Vivek Called It]

[EU Parliament Refuses to Condemn Political Violence]

[AI Fashion Show]

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