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 Coming Death of Capital

When I was a kid, my family had a pump house—a metal shed that covered the machinery that operated our well. Occasionally I'd need to go inside of it, a task I approached warily. Every time I'd open the door, I was immediately greeted by the sight, sound and smell of dozens (if not hundreds) of roaches, lizards, skinks and lord knows what other vermin frantically scuttling away to a safer, darker hiding spot. It was disgusting (especially the smell of their excrement), and I tread carefully.

Recently I got the idea to enhance my corporate social credit score by looking for certain ESG-related keywords on the websites of the approximately 2,100 dividend-paying companies I track on my spreadsheet (which I'll write more about in a future issue). I thought, "Instead of trying to rely on often ambiguous ESG scores from collusive rating firms that are trying to bring about the death of the free market, why not look at what each company is actually talking about and spending time and money on?"

I should take them at their word, especially since many of them are going to great lengths to measure everything from CO2 emissions to water usage in mind-blowing detail. There's a well-known saying: "What gets measured gets managed." The corollary of that is "What *doesn't* get measured (such as free cash flow) because you're too busy measuring other things *doesn't* get managed." If management is spending its time measuring, say, the number of pounds of opaque #2 plastic the company recycled, or the number of left-handed disabled minority trans employees it hired, it will result in less free cash flow and dividends for shareholders.

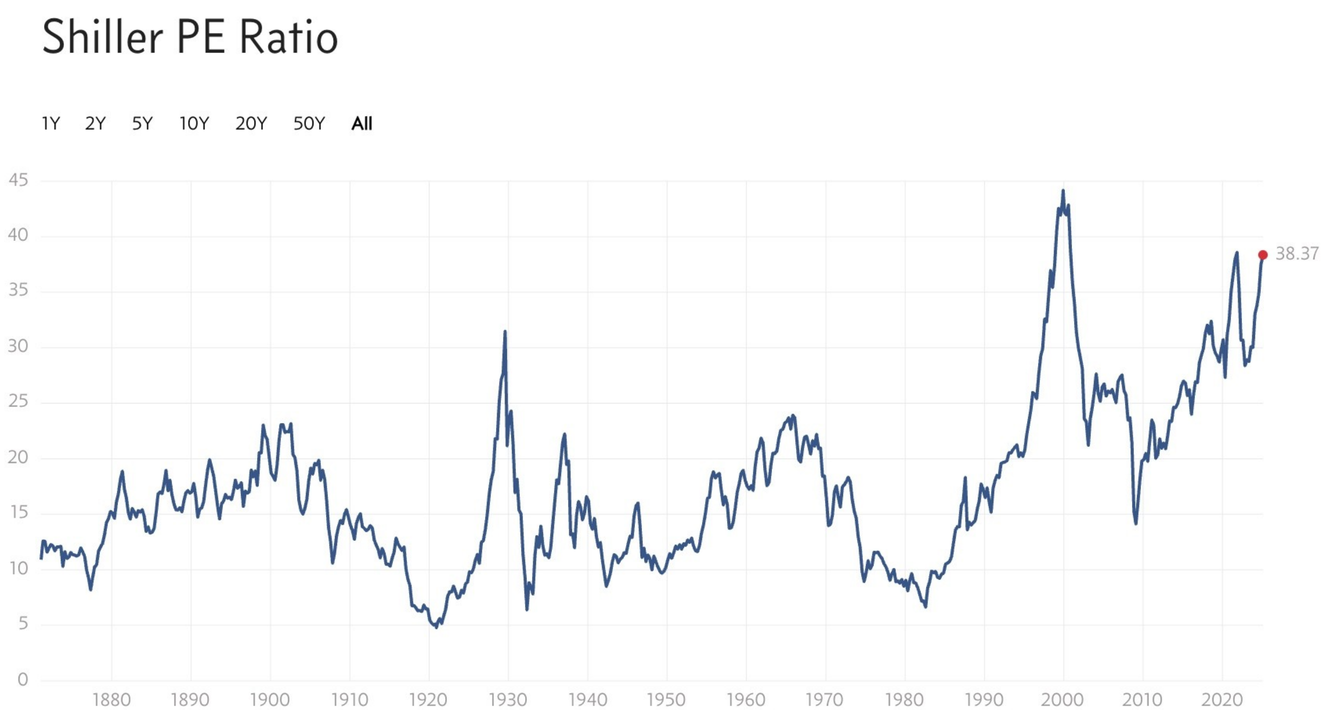
I decided to penalize a company with a -1 each time it mentioned a keyword such as ESG or DEI, because I wanted the score to capture the extent of its distraction (from generating free cash flow and dividends for shareholders), obsequiousness to woke asset managers, mindless corporate conformity to the biggest and most obvious hoax in human history (anthropomorphic climate change), and how much of the poisonous ESG/DEI Kool-Aid management had voluntarily quaffed.

As I went through the websites of various companies that currently pass nearly all of my other fundamental and quantitative screens except for current price (which number about 160 out of 2,100) and began to sum up the scores, I started to feel the same sense of revulsion that hit me when I opened the door to the pump house. It was like I had taken the Red Pill and was seeing the world as it truly was for the first time. I felt like a surgeon who opens up a healthy-looking patient, only to discover that their body is full of dozens of cancerous tumors. It reminded me of the old (but still intact) wooden lot sign on our property; when some workers brushed up against it, it collapsed because termites had destroyed it from the inside.

When investors discover that the companies in which they own a residual claim have become *de facto* social justice nonprofits and are spending much of their time, effort and money on things that have *nothing to do* with generating free cash flow and dividends for shareholders, the global stock market will crash. The value of an asset is equal to the present value of its future cash flows, discounted at an interest rate that reflects the risks. But if future cash flows are zero (because the company is now providing "important benefits" to a handful of "stakeholders" and helping the United Nations reach its 17 Sustainable Development Goals), the current value is also zero. Chasing after the fantasy of Net Zero will result in net zero cash flows and value to investors.

The dirty little secret about investing in equities today is that only about 1-2% of them have a positive expected return for shareholders. If current practices continue (and I think they will, unless lawsuits and/or Congress and the Trump administration can somehow stop it, because the big three asset managers [Blackrock, State Street and Vanguard]—as well as many others—are dominated by woke managers themselves and together control enough proxy votes to ensure that shareholders will "own nothing," as the World Economic Forum likes to say), then one day a butterfly somewhere will flap its wings and thus initiate a chain of events (which will be unnoticed and seemingly inconsequential at first) that will eventually jostle financial markets, and just like my lot sign, suddenly the stock market will collapse. Hardcore Leftists around the world will rejoice.

The vast majority of stocks will suffer a loss of at least 80%, especially since (1) the bulk of money invested in stocks is in index funds, (2) over 30% of the (market cap-weighted) S&P 500 index is invested in just seven stocks and (3) U.S. stocks are extremely richly valued (the current Shiller CAPE Ratio of 38.2 is essentially tied for the second highest ever going back to 1871, and is not far from the record 44.2 set in 1999 just before the Dot Com crash). I understand that many investors are excited about a possible new Golden Age under President Trump, but returns are also affected by how much you pay for an asset. Are you willing to pay $38.20 for one dollar's worth of earnings each year (growing at whatever the future growth rate is)? As a value investor and contrarian, I'm not.



Equity investors have always faced a number of risks that could permanently impair their capital. But like a novel virus, they've never seen a threat like this before, and it's been disguised as sustainability and good corporate governance, so it's not fully on their radar. It's like suddenly discovering that in addition to all of the other risks of daily life, you now also need to worry about being abducted by aliens. It's that weird, too, because most of the threat comes from the professional asset managers that investors have hired to manage their money for them, who have a legal fiduciary duty to seek to maximize the return and minimize the risk for their customers.

Many corporate executives—who are hired (and are well compensated) to manage a company for the benefit of the shareholders)—have either voluntarily reneged on that duty due to their own political beliefs or to signal their supposed virtue using Other People's Money, or caved to the woke asset managers so they could keep their compensation package and retire comfortably in a few years. Mom & Pop investors will never know what hit them. It's always the punch you never saw coming that gets you.

In closing, the silver lining to all of this is that when the baby gets thrown out with the bathwater (i.e., all the other stocks in index funds), quality companies that are still focused on creating value for their shareholders will be available at bargain prices, implying high expected returns. Be sure to have some cash ready to back up the truck.

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