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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Warning Signs for Stock Investors

Note: I wrote nearly all of this on Wednesday morning, before Trump's tariff announcement that afternoon.

Most investors are probably blissfully unaware that the U.S. stock market is close to the record (as in 1929) valuation. For example, as of the end of 2024 (the most recent data available), the 10-year cyclically adjusted price/earnings ratio was 31.4, so investors are paying $31.40 to own $1 worth of earnings (plus or minus its future growth rate) forever. Warren Buffett's allocation to cash (50.76%) is just shy of his all-time record of 50.96%. The Buffett Indicator (total market capitalization divided by U.S. GDP, which he says is the best single measure of stock market valuation) is currently 188.9, BY FAR the highest in 20 years (which averaged 122), implying a future return of 1% per year for the U.S. stock market, including dividends.

Equity investors get whatever is left over after a company pays its expenses (including interest and taxes) and spends money on research, development and investments, so they should be the most sensitive to changes in that number. Since an unexpected event (which could be anything from a massive new tax regime and trade war to a butterfly flapping its wings in the Amazon) could come along at any time that could upset that delicately balanced apple cart, I thought now would be a good time to review the number of warning signs that investors can notice if they're not blinded by greed.

High short interest: Short interest is the percentage of a company's shares that have been sold short by short sellers, who are Smart Money. Generally, they have done extensive research that has uncovered significant negative information about a company that the market is largely unaware of, and are so certain about their bet that they are willing to accept a maximum gain of 100% and a maximum loss that is theoretically unlimited. Therefore, I respect the shorts.

Insider selling: Because corporate insiders have access to more information than non-insiders, they are Smart Money. Now probably most insider selling does not necessarily imply they are bearish, because the sales may be part of an automatic sales plan or they may be reducing their unsystematic risk to that company, etc. Insiders tend to sell early because they are allowed to sell only during certain periods each quarter.

A low Beneish M-score: This is the product of a mathematical formula that uses eight financial ratios to determine a probability that a company's management has manipulated its reported earnings. Because I'm an investor and not an accountant, earnings are irrelevant to me (I focus on free cash flow instead), but I use this score as a proxy for management's honesty. When a company experiences financial distress, or at the end of a long bull market when valuations (and investor expectations) are high, there is a lot of pressure on management to make a company's financial condition appear better than it actually is.

A company fails to increase its dividend within the last year (bad), reduces its dividend (worse) or eliminates its dividend (the worst): This is a sign that a company is experiencing financial distress and/or that management's interests are no longer aligned with those of investors.

A senior executive suddenly resigns (or worse, is terminated) or a company restates its past financial statements: This is not a good look, as it usually indicates that something is rotten in Denmark.

You start to hear about a stock after recent high performance: Usually you'll first hear a mention in the financial media, then Jim Cramer will talk about it, then you might hear some people talk about it at the gym or a social event. By the time you hear about it from the tennis pro or (famously) the shoeshine boy, watch out because the end is near. If I ever start to come up with a list of my iron laws of investing, this will be among the first: *If you hear people talking excitedly about an investment after it has had a high recent return, run away!* That is not where you will find a high expected return.

Management starts spending a lot of time, money and energy on activities that have nothing to do with (1) ensuring its financial survival and (2) maximizing shareholder value: In recent years, I have repeatedly warned about the sudden and shocking transformation of the vast majority of corporations around the world into de facto social justice nonprofits. The investment world hasn't seen anything like this since as least the Great Depression, yet the vast majority of investors still haven't figured this out. When it comes, the repricing event will be the most painful investment event of our lifetime.

Higher leverage: Since 2009, many corporations have gorged on artificially cheap debt thanks to the Federal Reserve. But they weren't alone: Consumers and governments at every level did the same thing, so now the U.S. is drowning in $103 trillion of debt (and unfunded federal government liabilities of over $200 trillion). Debt creates *fragility* because it magnifies losses.

A surge in initial public offerings: The (Smart Money) owners of a private company time its sale to the (Dumb Money) public so they can get the best price, which invariably is when retail investors are ebullient and therefore willing to pay a rich premium. When many private companies go public (such as in 1999 and 2000), the end is near.

A stock or asset is used in a new investment product (usually an ETF): Investor demand drives the supply of ETF products. Invariably, investors demand these products after that theme or asset class has had a high recent return. ETFs close when investor demand wanes (which is also when value and thus expected return are usually the highest). Similarly, you can track recent flows of investor cash into and out of individual ETFs. Investors chase returns, not value, so it pays to be an independent thinker and stand against the crowd.

A company changes its name: Normally, a company's name is the biggest part of its brand, which is usually a valuable asset that it doesn't screw around with. In the last decade or so, it has become fashionable for some companies with outdated-sounding names to change them to something that sounds more “with it” (but is nevertheless meaningless). For example, Corn Products International changed its name to Ingredion. I'm not talking about that kind of name change, I'm talking about a name change to deep-six a well known name that has become a permanent millstone around a company's neck. Perhaps the most famous recent example of this was when Monsanto was able to replace its name with the much more respected Bayer after the latter acquired it. A company changes its name because it wants people to forget about massive value destruction, a big scandal, etc. Usually a name change doesn't alter its fate.

In conclusion, like a volcano or an earthquake, the stock market produces a number of early warning signs that can be acted upon if Recency Bias and greed don't prevent one from noticing.

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