Current Threats to Your Financial Security

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Introduction

In the past few weeks, the US stock market has hit all-time highs. Many investors interpret this as good news and believe this is a signal that both the economy and the market are healthy and safe again. I have prepared this report to point out current, serious risks to the both the US stock and bond markets.

When making the decision to buy, hold or sell stocks and bonds, most investors focus on price trends and buy rising markets, hoping that positive trends will continue. Market trends are very important, but they are often misinterpreted.

The market trend has been up for over 4 years, rising over 130% from the lows. It is a dangerous time to own stocks because the threats to the stock market are as great as they were in October of 2007 when the US stock market fell 54%. The market has recovered, but the reasons it fell persist. Will you sell before or after the next crash?

Perhaps the greatest challenge that investors face is to appreciate and fully consider the difference between the price and the value of a company's stock. Prices are not set in a "fair" or rational manner. Prices are determined by the supply and the demand for stocks. **The demand for stocks is truly extraordinary: there are about 50 million retail investors, 20,000 hedge funds, pensions, mutual funds and registered investment advisors, and there are about 600,000 salespeople representing Wall Street brokerage firms.** The supply of strong and liquid publicly traded companies is extremely limited. There are no more than 300 to 400 of such companies. Given the supply and demand conditions, what is the likelihood that there are dozens of great investments waiting for you? How could *your* stocks get overlooked by the millions of other professional and retail investors? It is no exaggeration to say that almost all stocks, at almost all times, are priced "very richly." Therefore, finding bargain-priced stocks is nearly impossible at almost all times, with the rare exception being periods after the market (or a specific sector) has suffered a steep decline. *Patience pays.*

People buy stocks when they feel most optimistic and sell when they feel fear. *Emotions determine stock prices.* When people are most optimistic, prices are highest, and the opposite is also true.

Where are we now? On May 31st US consumer sentiment rose to the highest level since July of 2007. Peaks in consumer sentiment are well correlated with peaks in the stock market. That is logical; people buy stocks when they feel good and buy more as the market peaks. After consumer sentiment peaks, significant market declines follow. Current data suggests that investors feel too much confidence.

Throughout US stock market history, we have seen stock prices swing by 25% to 50% and more, sometimes in as little as a few months. Such movements are not the result of the rational analysis of facts. In reality, all companies together cannot be worth $25 trillion on one day and $35 trillion three months or even 3 years later!

Consider the following: In the past 12 years the ***prices*** of GE, Microsoft, Cisco and Intel implied that the combined value of these companies was $2.3 trillion, which later fell by about 85% to $0.3 trillion. These four companies lost $2 trillion in **price**. Notice that I did not say they lost $2 trillion in ***value***. The buyers who overpaid for them clearly did not know their ***value*** before buying them. The buyers bought them because they were the most popular stocks promoted in the media and Wall Street firms and because they were rising in **price**. The masses are lured into buying stocks at any price just because "stocks might go higher." **We must compare the price of each stock to the value of each stock.** Buyers and sellers of stocks have no idea how to determine the real value of a company. They gamble on price alone. The four stocks I mentioned earlier lost $2 trillion in **price**. Big name stocks hurt investors the most. No matter how big the name is, when the market falls, they will fall also. What strategy do you use to avoid holding stocks before major market declines?

Stocks will not only trade significantly higher than their real value. They will also eventually fall in price, making it possible for the stocks to be purchased for far less than their tangible value. This price reduction usually comes with a market decline following a market peak. At their lowest price points, it is likely that these four stocks were *highly* undervalued. Yet that is when investors could not stop themselves from selling!

Learn from the past. Recently investors "mispriced" the *value* of a very popular consumer products company. Just 19 months ago this company's share price implied that it had a value of about $335 billion. Ten months later the price of that stock shot to a price level which implied the company had a value of $660 billion. Just a few months later the share price fell to a price that implied it was worth only about $410 billion. In the span of 19 months, the price of this company rose by $325 billion and fell by $250 billion. Is it even remotely possible that the actual value of a company is so undefinable as to vary by more than $1/2 trillion in just 19 months? The lesson: **The bigger the name, the more likely it is to be grossly over-priced, volatile and risky**.

There are three basic and crucial steps to investment success:

1) Use a rational and conservative method of analysis for valuing a company.
2) Do not to pay much more for a stock than the liquid net tangible assets of the company.
3) Never follow crowds.

In order to protect capital, it is crucial for investors to conservatively measure the value of a stock before buying it. Wall Street's job is to create the most optimistic case for buying stocks at all times. How else could they get people to buy stocks even as the market hits historic peaks? The market will rise and fall. If you only buy conservatively-priced, value stocks, you will very likely avoid the major losses caused by major market declines. We believe the best time to buy stocks is after the market has declined significantly. If you are always fully invested, how will you have cash to buy stocks after the market falls?

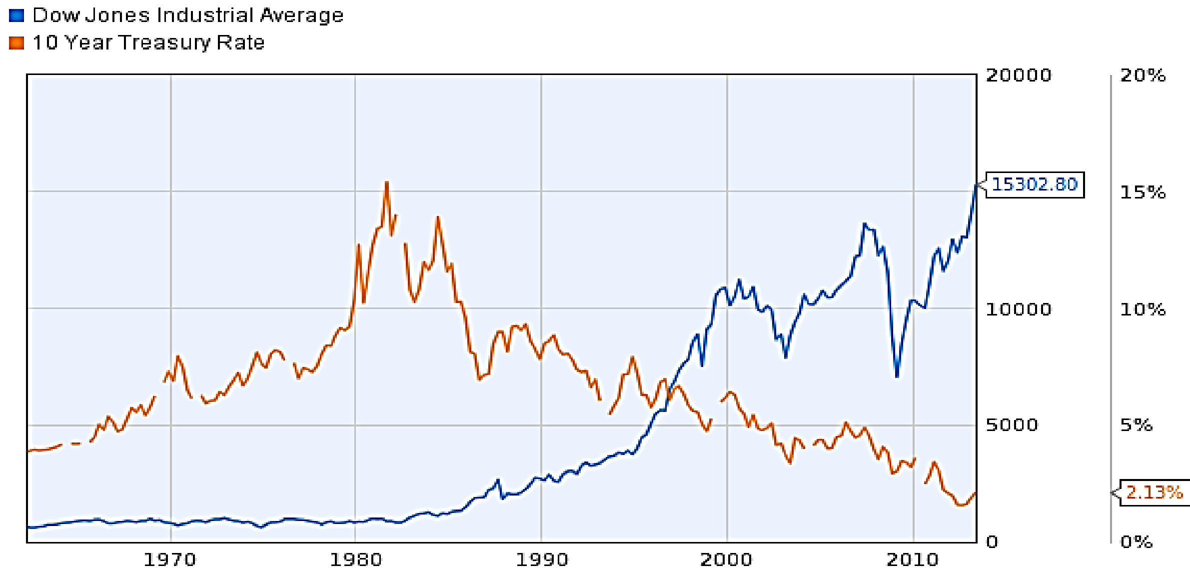
If there were not a significant difference between price and value, there would be no reason to study a company's business, their competition, and the financial statements of all competitors. To figure out what a company is worth, we would only have to look in the newspaper at the price of its shares.

In the following pages we review three serious threats to future stock prices:

1) **Increased Interest Rates:** Higher rates will cause lower stock and mutual fund prices;
2) **Corporate earnings, sales growth and debt growth**: In the past decade an increasing percentage of large companies report cashless earnings, rising share prices and greater debt;
3) **Growing GDP vs. Growing Debt**: A great majority of the GDP growth since 2000 has been fueled by tremendous increases in government and corporate debt. This debt burden is an anchor, a major drag on future economic growth.

1) Increased Interest Rates

The greatest danger to stocks, bonds and mutual funds may be increased interest rates. We believe higher interest rates are coming, and perhaps soon. There is a straight-forward "cause and effect" relationship between higher interest rates and lower stock and mutual fund prices. When rates rise, stocks will fall.



The interest rate chart above shows that interest rates rose steadily from the 1960s until the 1980s. During that period investors were satisfied with high yielding CDs and annuities and largely ignored stock. However, since interest rates have declined over the past 30 years, more and more Americans have turned away from low yielding CDs and annuities and placed a larger portion of their savings in the stock market. In the past 12 months, interest rates have reached the lowest point in US history. If history repeats itself, interest rates are certain to rise. This is critical for three reasons:

1. When interest rates are higher, many investors will sell stocks for higher yields offered by CDs, money market funds and annuities.
2. Bond holders will suffer losses of 20% to 30% or more, just as they did in the 1970s.
3. Borrowers will pay interest of 3 to 4 times what they are currently paying. That will cause increased budget deficits for federal, state and municipal governments as well as businesses and households. Banks, insurance companies and pensions will take the large losses.

The implications of higher interest rates are widely understood both in the financial market and in Washington. This is one of the reasons why Wall Street and Washington are working so closely together to keep rates low. Rates simply cannot remain low forever. When interest rates rise, it will present an unprecedented challenge for policy makers, businesses and investors. Investors who own stocks or bonds are betting that rates stay low. When they rise, the crisis of 2008/9 will be repeated.

2) Corporate Earnings, Sales growth, and Debt Growth.

What are earnings without cash worth**?** Since 2000, corporate revenues grew at about the same pace as GDP growth. The GDP grew by 66%, Real Disposable US Incomes grew by 30%, corporate debt grew nearly 3 times faster than corporate revenues, and the tangible equity of many of the largest companies actually declined. Yet these same corporations reported “earnings” that were 219% higher than earnings in 2000. Can companies realistically produce cash earnings growth that are 2 to 3 times faster than the rate of sales growth? How long can corporate debt grow at a rate that is 2 to 3 times faster than sales growth? How much is a future dollar of earnings worth if:

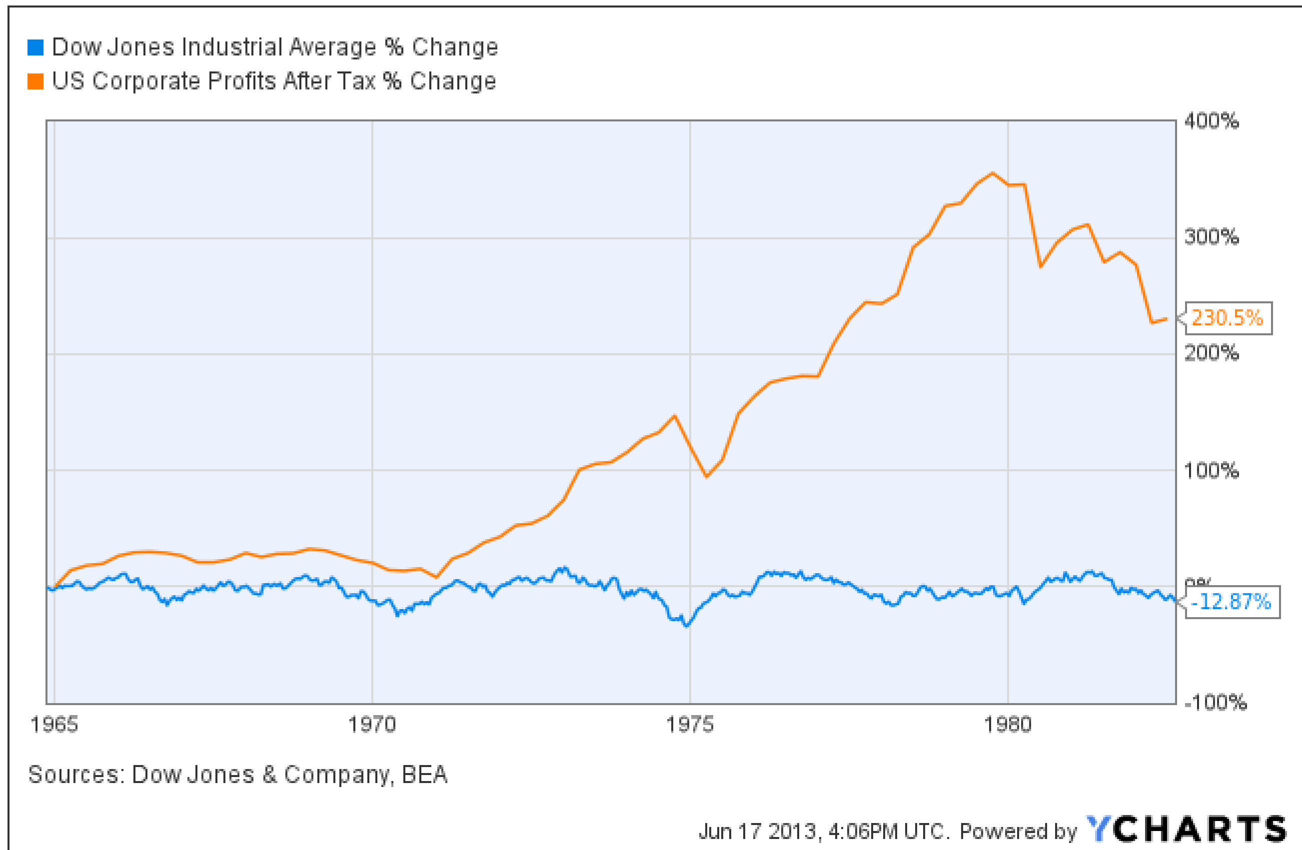
a) A company is far deeper in debt.

b) It has only modest revenue growth.

c) It has less tangible equity each year.

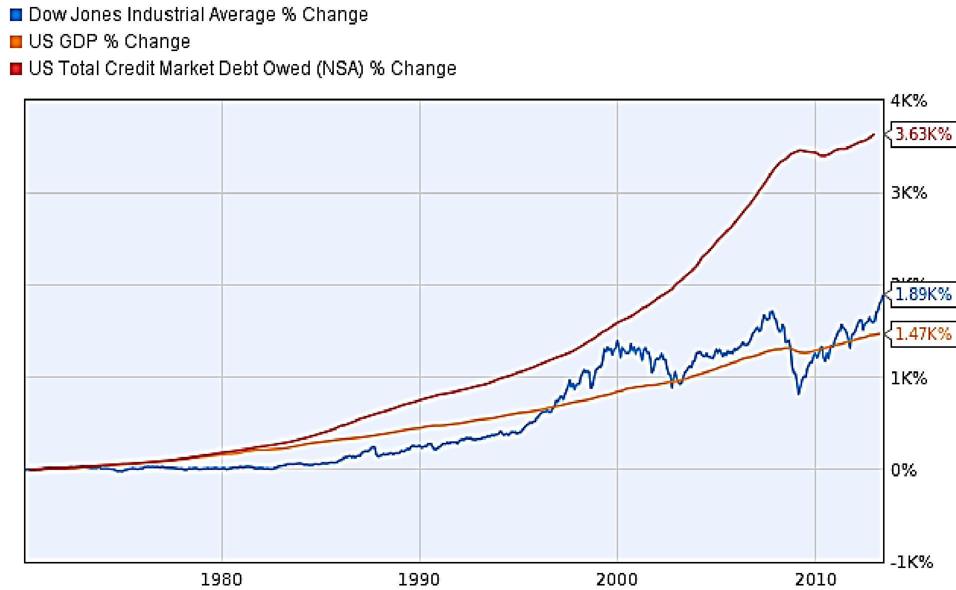
In our view, a company with rising debts, falling tangible equity and very modest revenue growth is an accident waiting to occur, no matter what they report in so-called “earnings.”

In the past decade an increasing percentage of large companies reported cashless earnings, rising share prices and greater debt. Many years ago, Abraham Briloff, CPA, Ph.D., warned us, “Financial statements, like fine perfume, should be sniffed not swallowed.” Sound advice: Follow the changes in both a corporation’s cash and a corporation’s debts.

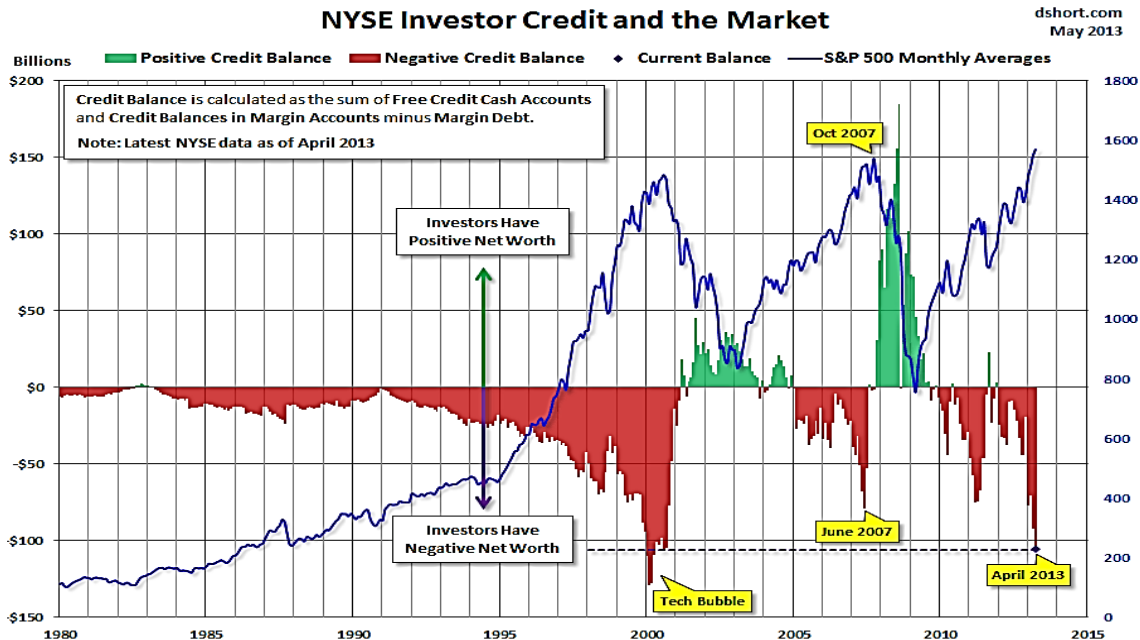


3) Growing GDP vs. Growing Debt

Many investors believe that when the Gross Domestic Product grows, it indicates that the economy is healthy and stock prices will head higher. Such is not the case. There have been very long periods when the Gross Domestic Product rose and stock prices stagnated or even fell. In the past 20 years, and especially in the past 7 years, the GDP has been growing, however, debt levels of both corporation and the government have grown at a much faster pace. We believe that when a nation's debts and corporate debts grow substantially faster than their sales and tax revenues, GDP growth not only fails as an indicator of economic health, it actually indicates a greater likelihood of future financial and economic troubles.



The chart below strongly and clearly suggests that after markets rise substantially ***on borrowed money***, they fall substantially. The only other time in history when investors have borrowed as much money to purchase securities was during the tech bubble of 2000.



The chart below reveals that the Federal Reserve Bank (FRB) purchased well over $2 trillion in US government debt in response to the crisis of 2008. They bought these bonds for three reasons:

1) There were no others buyers at those rates.
2) The stock market was falling, so they "gave" money to banks to make it possible for banks to loan money, enabling people to buy more stocks and bonds.
3) If they did not buy these bonds, interest rates would have risen substantially.

What will happen when the FRB tries to sell these bonds? Will interest rates rise dramatically? Will stocks and bonds fall? How do you factor these two risks into your investment decisions?

Conclusion:

At this time, the risks of a stock market crash are very high. Below are our beliefs about the stock market and how best to protect retirement capital:

1. Most companies in the Dow Jones and Standard & Poor's 500 will survive any economic crisis.
2. At some point, perhaps soon, stock prices will decline greatly. They fall the most after they rise the most. This process has recurred throughout market history. Crashes will always be with us.
3. It is best to pay the lowest price for stocks. The lowest prices are available after markets crash.
4. It is best to sell stocks after the market rises significantly. Never try to sell at the "best" price.
5. If you sell most stocks after the market rises greatly, it is very likely that you will avoid significant market declines. Since no one is able to know how high a stock will rise, it would appear that we always sell too soon. This affords us the best opportunity to get out before a crash.
6. The only way to be certain that you will have money available to buy stocks at the best time, which is after the market has fallen, is to sell stocks after the market has risen greatly.

All of our efforts are driven by the desire to limit losses. We believe the above guidelines are appropriate for an investor's most conservative retirement savings.

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