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Avoiding Excessive Investment Risk and Protecting Your Nest Egg

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Introduction

This e-pamphlet contains several essays about investment risk. The goal of the publication is to open investors' minds to hidden risks rather than offer a magic way to get rich quick. The old joke is that "the fastest way to make a small fortune is with a large one". Avoiding excessive risk is important because the asymmetric nature of risk means that if your stocks go down 50% then to break even they need to go up 100%. Since there were two crashes where stocks dropped 45% (one in 2002, the other in 2009) then someone could have lost 75% of their assets in certain cases if they lost roughly 50% twice they would have only 25% remaining. Some experts feel a third stock crash is coming so that would further put investments at risk.

The key to investing is the cash flow/income method using a long term series of accounting data to estimate sustainable cash flows and then estimate a stock's value based on cash flow. The long term cash flow statistic of the PE10 shows the stock market is overpriced by 60% so it needs to drop about 38%. And in an unprecedented situation, bonds are also overpriced at the same time, thanks to the Federal Reserve's QE manipulation.

Another key is to avoid being stampeded by the bull market herd of cattle that are chasing after incorrect, overpriced investments. This means staying calm during an era of low yields and waiting patiently for the crash to get a buying opportunity.

Also one should avoid in most cases junk bonds and Emerging Market bonds (unless very carefully chosen with an eye towards risk and preferably in a Long-Short fund).

2013 Financial Predictions For 401k Investing

This year has seen stocks rise by a huge percentage and bonds were hurt by rising rates. People wonder what are the 2013 financial predictions for 401k investing. Bonds could go down more if rates rise when the Federal Reserve raises interest rates, which could happen next month through "tapering" of the bond purchase program. If stocks went up a lot this year does that mean they will go down, thus damaging their 401k? If they put their stock allocation into a 401k and diversify by putting their bond allocation in a taxable account would that be bad for tax planning purposes? Investors should seek independent financial advice about investing and tax planning.

The best way to make a 2013 financial prediction for 401k investing is to first realize that market timing is difficult and unreliable. Instead one should focus on strategies such as "market boycotting" where an investor simply refuses to buy an asset if it is overpriced, and better yet when it seems to be a good time to buy, one should insist on waiting to buy at a discount so as have a built in margin of safety. Based on metrics such as the Shiller PE10 which is now at 24 (normally it should be in the mid-teens) then stocks are overpriced, which implies they could go down roughly 38% to about 1050 for the SP. No one knows when a catalyst will provoke a panic that will make stock prices drop down to fair value.

Another strategy for 2013 for 401k planning is to remember that these are retirement accounts so they need to be invested more conservatively than a taxable account, which implies that perhaps bonds aren't so bad after all as long as duration is short term.

It may be best to invest a 401k in "Stable Value funds" which are usually only available in a 401k, or a short term bond fund. Both pay a greater yield than if you stuffed cash in your mattress but not much more than that. But if stocks cost you a 45% capital loss then you will respect your "mattress investment". There was a 45% stock market crash in 2001-2002 and again in 2008-2009. Some theories indicate there are supposed to be three crashes before a "cleansing phase" creates a new bull market, so be careful that you are protected during the third crash.

The stock market bulls main reason for saying stocks are OK is because the current year's earnings PE ratio is reasonable, however, when one looks into the detail and sees that earnings (as a percent of sales) are actually abnormally high and may go down to normal levels then PE ratios are too high even on a short term basis (in addition to being too high on a 10 year PE basis). The other reason stock market bulls like stocks is because interest rates are lower than yields on some dividend paying stocks. Unfortunately that type of logic is based on negative thinking that because a person is offended by low bond yields they take out their anger by buying a different asset. This is not right, because one should pick investments based on building a positive case for an asset class from the ground up instead of simply getting mad at bonds because the yield is low.

If the Fed raises interest rates then that would undermine the argument of stock market bulls. And an improving economy justifies future rate increases by the slow poke Fed which will certainly undermine stocks.

I have written an article "Fiscal Cliff to damage 401k's", **Even though the Fiscal Cliff was milder than many had thought it was still a risk that could reoccur.**

If Stocks Are Too High Why Didn't They Crash by Now?

When Will Stocks Revert Down to Fair Value?

Stocks have been high and rising for a several years. The current era reminds me of the ten year bubble in real estate and mortgages from 1997-2007 when the bubble seemed unstoppable and it seemed foolish to speak out against the bubble. Every year the bubble got more aggressive. The more that it expanded, the more the bearish critics of the bubble looked unwise. Overlapping this era was the 1997-2001 tech stock bubble. Investment advisors who advocated conservative fundamental analysis techniques instead of "momentum trading" or following the herd were left behind and discredited. But ultimately those who advocated fundamental traditional valuation metrics were vindicated.

Never before has so much debt been used throughout the world at the same time. Previous economic cycles did not have so much stimulus and growth in Emerging Markets (including commodities) that were fueled by a huge debt bubble. Thus the experience of previous cycles will not be as relevant during this cycle. Emerging Markets may be coming out of period of excessive use of debt and may find that adding more debt won't produce a reasonable return. The resulting reduction of global growth rates may harm the U.S. stock market. Half of the profits of U.S. companies come from Emerging Markets. Because EM countries don't have the deep pockets and deep social safety net of Developed countries then when EM countries suffer from a downturn they will have less money for consumption and presumably won't be able to contribute to the profits of U.S. stocks.

An article in Barron's on 8-5-2013 "Bracing for the Next U.S. Recession" quoted economist David Levy who said the economy can't take the stress of higher interest rates and thus a recession may occur.

Investors should be patient with holding a bearish portfolio and not be upset that stocks continue to go higher. The Small Cap index went up at a very fast pace in the past 12 months which implies either a massive business boom of stunning proportions will occur or else it is a bubble so be careful. The SP at 1700 today is still roughly 10% below its inflation adjusted high of 2000, so even now over a 13 year period it hasn't beat bonds, even with a 2% dividend. Remember bonds paid roughly 6 to 4% for many of the past 13 years and produced capital gains until 12 months ago. From June 2000 to now $100 invested in Long Term Treasuries would be worth $243 today versus $129 for "Large Cap Blend" stocks, assuming compounding of dividends and interests by reinvestment was done in a tax deferred account with no commissions or fees. (This is simply the index return and not a return of an actual mutual fund)*.

I admit part of the bond rally was a fluke caused by Federal Reserve manipulation, but the manipulation also helped stocks. Of course since bonds went up so much then it is best to assume they have reached their peak and may go down in value.

GDP Rise to End QE – Will Stocks Fall?

GDP Release Today Gives Green Light For Fed Tapering

The quarterly GDP figures were released today July 29, 2013 with a 1.7% growth, the previous quarter was 1.1%, and for the year 2012 it was 2.8%. Since interest rates are at a very low level then the Federal Reserve program of stimulation by Quantitative Easing (QE) seems excessive and unwarranted so they will start tapering QE soon.

The reduction of stimulus and the increase in interest rates as a result of tapering will create headwinds for the stock, bond and real estate markets. Rising interest rates make it harder for leveraged speculators to own assets, so they may be forced to sell which may contribute to a vicious cycle of liquidation.

If the great crash of 2007-09 was only a 5% dip in the GDP and that has now healed and last year GDP grew 2.8%, almost at the level of a prosperous, full employment economy (where GDP would be 3 to 4%), then clearly the time to end QE has come.

The worst casualties of the new era of rising rates will be short term speculators who use cheap margin money to buy junk quality assets with high yields. These speculators don’t want to give up their addiction to getting yields of 10 to 19% (after using leverage) so they will place a stop loss order on their assets and wait until the last minute to sell. They hope to sell their junk quality assets to “The Greater Fool” the night before the crash. Except no one can pinpoint when a crash will start so one needs to be out of junk assets early rather than late. Also, during a crash the shortage of buyers mean that prices will fall far below the stop loss order price. A hard crash could make some assets go down 40% in a day so a stop loss order to sell on a five percent dip might not get filled until the asset had dropped 40%. If levered up 2 to 1 then the loss would be 80%. It is possible with a “purpose” loan (where the purpose was to do something other than invest to get a 70% LTV margin loan. If an asset was sold at a 40% loss with only 30% equity then the investor would have negative 10% equity (a 110% loss of equity) and would have to liquidate other assets to pay off the margin loan.

Assuming I’m correct that the PE10 theory is correct and that stocks are overpriced by 60% then crashes caused by overleveraged speculators who buy junk quality assets could trigger a repeat of the 2009 crash. If we are fated to relive such a crash then one should avoid owning junk quality assets and avoid leverage.

The WSJ had an article today "P/E ratios to drop 20% in coming years", which they attributed to rising interest rates. The article seemed to refer to the current year's PE instead of the higher (riskier) PE of 24 that is calculated using the 10 year PE. If the article is correct it would imply stocks will drop 20%. In my opinion, based on the ten year PE they would drop 37% and temporarily drop even lower before reaching fair value at at drop of 37%.

I have written an article "Improving employment rate to hurt investments".

A New Paradigm of High Margins?

PE 10 ratio is valid and profit margins will mean revert; stock prices are overpriced

The 10 year inflation adjusted Price-Earnings ratio is what I use to decide stocks are overpriced or underpriced. But what if a new paradigm shift has occurred and thus the ten year average is irrelevant because we have entered a new utopian world where high corporate margins will remain high instead of mean reverting. Margins are about 9% of sales versus a mean of 6%. The extra 3% profit margin explains why stocks are so high (they are about 59% overpriced using PE10 theory). The bull's theoretical justification is to assume that the global economy is in a period of continued economic weakness where corporations can get labor and materials cheaply thus keeping profit margins high. However, the economic weakness would imply that consumers would need to cut back on purchases, especially of high margin goods. Assuming the stock market is fairly priced and is efficient then the market is telling us that we live in a full employment economy in which case the Federal Reserve needs to raise interest rates which will hurt stocks and corporate margins.

On the other hand, assuming the economy is weak and thus exhibits deflationary or disinflationary phenomena of excess competition and price cutting by workers and vendors then at some point those workers and vendors will realize they have suffered from a reduced income and will need to cut their consumption. If the bulls are right then reports of a tight labor market with rising real wages for the more skilled sector of the population will certainly mean that corporate employers will no longer enjoy cost cutting from "fire sale" rates of wages and vendor's services.

If labor has had its share of corporate revenue drop from 55% to 50% and now that may be reverting back to the higher figure then corporate profits would drop. If labor claims a 5% extra share of revenue this is 5/9ths of corporate profit margins. (Five percentage points of sales revenue going to labor where corporations used to make a 9% profit margin would mean labor cuts margins from 9% to 4%). This implies a 56% drop in profit margins before counting annual sales growth. Increasing sales, assuming workers eventually get an extra 5% of revenue would not result in improving margins after margins had been cut to 4%. So a corporation that increases sales by 5% in a year and increases labor costs by a one-time 5% real increase would take a $100 corporate profit to $105 before wage increases and back down to $100 after wage increases. Thus in real, inflation adjusted terms, corporate profit would have shrunk 1 or 2% depending on which inflation index is used. Of course this research problem is a multi-dimensional one because

technology could make workers more efficient without giving them an increase in future sales revenue and future increases in worker's income, especially if due to overtime work, could result in consumers buying more full service high margin goods and services because they are too busy to use low cost do-it-yourself vendors.

In order for the bulls to justify today's stock prices, which violate the PE10 theory, they would need to bear the burden of proof that some magic new workplace technology and procedures would increase productivity so that workers could get more income without increasing their share of corporate revenue and at the same time corporations would increase sales. Remember how investors were fooled by the tech bubble of 1998-2000 into thinking there would be a magic new technology that would change the way businesses operated. News stories were published claiming that many brick and mortar stores would be shut down and everything from haircuts to clothes would be shipped from Amazon by UPS to consumers.

When a significant recession occurs it takes several years for the unemployed to retool their skills and establish a new career. During the recession workers and vendors are available at low prices. At some point the tide will turn (or has) and the low paid rookie will be a fully skilled journeyman in demand who can command higher wages.

Wages, employment and inflation are lagging indicators. As the economy continues to recover then these profit reducing things will eat up a greater share of corporate revenue thus lowering margins to mean reversion. Small cap businesses (many of which are not publicly traded) and independent contractors tend to thrive when the economy gets better because giant companies face supply bottlenecks and labor shortages and thus need to hire small companies to assist them. If the economy continues to recover then these sources of low cost vendors will dry up, eating into the profit margins of large publicly traded companies. One may think EM countries are a source of cheap and plentiful labor, however, the problem with EM countries is that they have a limited number of skilled workers and this limit creates bottlenecks which may inhibit their ability to grow rapidly. Thus one shouldn't expect a flood of seasoned high quality highly skilled workers from EM countries to help lower or stabilize global corporations' labor costs.

I have written an article "Market headed for new highs" where I discuss the dangers of assuming stocks will continue to rise.

Tech Stock Crash Makes Bonds Look Better

Tech Crash Shows Hidden Risk in "Safe" Stocks

Today July 19, 2013 Microsoft and Google share prices went down because of lower earnings. Microsoft went down 11.4% in one day; Google only went down 1.6%. See the WSJ article. In recent years Nokia went down from 28 to 4 from the high of five years ago. Blackberry (BBRY) was $134 five years ago and is now 9. Apple went down from $705 to $385 and is now $425.

Some of these companies have been considered very safe (MSFT has a rare AAA credit rating for its bonds) and yet their share prices have plummeted, except for Google's share price. The excuse is that PC sales are being stolen by smartphones but smart phone manufacturer Apple's share price has dropped 39% from its peak share price, so many quality tech companies have experienced surprising declines in share prices.

People worry bond prices will go down when the Fed raises rates but those worries are minor compared to worrying about the possibility that big, healthy tech stocks suffer significant losses.

I disagree with the allegation that if stocks pay a 2% or 3% dividend then why not avoid bonds and buy stocks. With stocks you expose yourself to a much more significant risk of permanent loss of principal even if the company survives. Remember when Cisco was $80 in 2000 and it plummeted to around $10 two years later and is now $26.

Based on conservative PE ratio metrics and a reversion to the mean for profit ratios as a percent of sales Facebook share prices could go to $7 a share, Apple's to $100 or at least down to $200. No one thought Cisco would go from $80 to 10 in two years but it did. Such a crash would cool off investors' enthusiasm for non-tech companies.

One wonders if declining tech stocks will hurt Silicon Valley residents who may hold too much tech stock and too many employee stock options. If tech workers suffer from a tech crash then local real estate will be weakened. Since Silicon Valley real estate appreciation has pushed up the average housing appreciation rate for the country then a reversal in this area can lower nationwide appreciation rates.

I have written an article "Do Facebook's earnings indicate the market has peaked?"

Are You Prepared for the Next Crash?

Risk of Dangerous Flash Crash From The End of QE

As the Federal Reserve's Quantitative Easing gets wound down then investors may panic and sell off the bond holdings causing the price of bonds to go down. Currently many advisors like the idea of investing in leveraged assets that borrow money at close to zero and then get a yield of 2 to 4% and lever it up. This is very dangerous because if the Fed ever decides to raise rates to normal levels then there will be a massive stampede to get out of these type of speculative investments. The rationale behind investing in these things is that someone can somehow time the market and will magically know a few days before rates rise that it time to get out. Or possibly they will simply hope to use program trading that triggers a stop loss order. That won't work if it occurs during a Flash Crash.

The problem with bond investing is that the experts may have become addicted to the past 30 year bond bull market and may be so in love with bonds that they may not be objective about when to sell. The risk is the bond speculators may think they can outsmart the market and get out in a year or two just before rates go back up, but they may find it is too hard to time the market. Investors don't want to give up the higher yields that come from leverage or from junk quality or from accepting duration risk to earn the "term premium".

The analogy could be that if someone lives in a rented house located next to an active volcano and has very cheap rent they may be tempted to keep staying in the house to avoid paying higher rent. They fantasize that they can time the volcano and maximize their stay in a rental house while paying a very low amount of rent. The problem is when the volcano blows they may not be able to escape or they may encounter a massive stampede to get out.

The only solution is to get out early. It is easier to think clearly when the market is stable and boring instead of during a Flash Crash when your stop losses were triggered but there are no bids. That means giving some types of high yield investments even though it may be a while before the Fed raises rates. Stop losses and technical trading tools like 50 day moving averages won't work during a massive shift in investment paradigms.

If the stock market bulls are correct then we live in a utopian economy where all is well. If that is true then the Fed is tardy in its schedule of future rate increases. Eventually the overcautious Fed bureaucrats who worry about the massive numbers of unemployed will realize the database of unemployed has been warped by the modern Welfare state that has made it too easy to be unemployed. Then, the Fed will raise rates.

The greedy investors who use cheap borrowed money to invest in high yield assets will trigger massive Flash Crash like the one in May, 2010. Huge losses could occur in passive ETF's and in over-leveraged long term bonds and any over leveraged high yield asset. One should reduce portfolio duration to 3 or even less, avoid leveraged investments such as mortgage REITS. Avoid junk credit quality or else buy only the best quality segment of junk bonds usually rated only one notch below investment grade. Avoid or reduce the risk that EM countries may be hit harder in a crash than the U.S. market. Reduce risk by owning the most conservative mutual funds in a particular asset class. For example for EM bonds since they are usually BB or B quality try to get one with the least amount of risk in that asset class. Don't buy anything on margin. During a crash a margin clerk will sell the good things in a portfolio to meet margin calls because the bad things can't be sold at all, making good assets go down more than they should.

Don’t Be Fooled Searching for Yield

Savers and retirees today are upset that the yield on bank deposits is less than inflation. People remember fondly of the "good old days" in the 1970’s when rates were as high as 14%, giving a “real” inflation adjusted yield of 2%. The problem with those days was that tax rates were higher so a 14% yield could have been taxed at 50% combined state and Federal tax rate, resulting in a 7% after-tax yield. Then subtract 12% inflation and you get a negative 5% real after–tax yield. Today if you get 0.75% from a bank, less a third for taxes, then you get 0.5% after-tax or negative 0.5% real return (assuming you use the PCE estimate of 1.05% inflation).

In ancient times there was no banking system so people had to deposit their gold coins with a goldsmith who stored it in his safe for a fee. This was the first form of a bank deposit. Since people paid a fee then that was like getting a negative interest rate to secure their money. People also paid fees in the form of assay charges for buying and selling gold.

One may be tempted to think we would be better off going back to the gold standard of the 19th century but that era experienced price instability, usually deflationary. Thus there was a cost associated with the 19th century monetary system. That era also had a high rate of bank failures with no FDIC insurance, which was another cost (a form of negative real interest rates) that savers had to endure.

Thus much of the past was an era of negative real rate in the broadest sense.

The collapse of Lehman in 2008 resulted in a large, well established money market fund losing 3% of value even though the industry standard was to never lose value. This is another form of negative real yields on cash.

Historically long term U.S. Treasuries yielded a real rate of 2.07%. If inflation, excluding wartime and excluding the outlier era of the 1970’s has been roughly 2%, then long term Treasuries yielded roughly 4% of which a high income person got perhaps 2.64% after-tax. Thus the real after-tax, after-inflation yield for long term Treasuries over many normal peacetime decades might be roughly 0.6%, assuming a 2% inflation rate.

Jeff Gundlach claims that the Fed's bond buying (Quantitative Easing) program lowered rates by a half percent. So if he's right then rates would go up a half percent when QE ends and then we would be close to the long run average real after–tax, after-inflation return of roughly 0.6%. Savers should realize that people have had to deal with negative real returns since the beginning of time.

The Economist magazine ran a story claiming that people who deposit money into foreign currency denominated bank accounts do so based on the nominal yield and not the inflation adjusted real yield because they are irrationally chasing after the "money illusion" of nominal yields instead of focusing on real yields.

Before savers and investors explode with rage over low yields they should realize that usually correlates with an era when equity and real estate investments are riskier than normal due to depressed economic conditions. Investors should carefully explore alternatives to savings accounts while doing so dispassionately since low or negative real yields (on savings accounts and Treasuries) are nothing new, they are simply the price to pay to be safe in a high risk world full of bubbles, over-leveraged hedge funds, giant "Too Big Too Fail" banks, etc.

The alternatives that could explored include short term bonds, below investment grade bonds, bank loan funds, long-short credit funds, strategic funds that exploit and rehabilitate defaulted debt, and of course hedge-like equity mutual funds, equities with yield (or equities with no yield but rising value) and real estate. All are risky. After hundreds of years where savers suffered either negative real returns or a high risk of bank defaults what makes you think the world has suddenly become a risk-free paradise where you get a risk free positive real after-tax yield?

The current era is one of the best in history compared with the eras of constant numbers of uninsured bank failures or the risk of having a goldsmith who stored your gold lose your gold or the risk of living in a place with double digit inflation. MarketWatch had an article about countries with yields over 10%. Those are horrible places to store money and with inflation and taxes and currency devaluations even if there were no bank defaults you would get a large negative real yield.

Detroit Bankruptcy a Warning To Investors

Today, July 18, Detroit filed for bankruptcy. The city has $18Billion of debt. I have advocated a policy of avoiding "cliff risk" and seeking instead graduated risk investments. The problem with muni bonds is that they are a cliff risk investment where they can hold off failure for a while but when they do fail it may be a sudden sharp change in their status as an investment. By contrast a corporate bond may, if it declines in quality, degrade more slowly giving investors time to get out.

Another risk with Munis is that 95% of issues are never traded and are simply held to maturity. Thus a seller may find an extremely illiquid market which would result in the seller selling at an exaggerated loss. The way to invest in Munis is to use mutual funds so that it is easy to exit or enter a position. Thus if you own a bond mutual fund and forecast an increase in interest rates then you can redeem your fund shares instead of having to sell illiquid bonds while incurring very expensive Broker's markup/markdown (spreads).

The Munis with the highest rates are ones with long term duration risk. The risk is that the economy will revert to normal and interest rates will go up, making bond prices go down.

Munis are a "new" asset class that could be called "too big to fail". But there is always the risk that a city can't keep pulling a rabbit out of a hat and will eventually go bankrupt. Based on the idea of gambling on the "too big to fail" concept it may be OK to buy Munis, however, one must not forget the risk that "too big to fail" could be redefined to allow some Munis to fail. If someone wants to invest in Munis I suggest they use Institutional class of shares of a mutual fund, get a fund with lower than average standard deviation, higher than average Sharpe ratio, and middle or upper rank of credit quality (for Munis this is AA or AAA), and very importantly get a low duration (low maturity) fund to reduce interest rate risk. That will reduce the expected yield but one must avoid risk in the bond market since the waters are very treacherous now that the tide will soon go out for the Fed's Quantitative Easing, which has never before been experienced.

EM Bonds – Will a 1997 Style Crisis Repeat?

Emerging market countries' weakness makes their bonds less safe

Asian countries and other Emerging Markets countries have a current account deficit that has been growing. The current account deficit for many EM countries has been between 2.5% to 6.8%. During the prelude to the Asian crash of 1997 deficits were 4% to 10%.

The ability to earn foreign currency is what EM countries need to avoid a crisis. If the commodities boom is over because China's debt fueled over-expansion is cooling down then EM countries will have less economic activity which will make their currency more susceptible to a crash. The WSJ had an article about this.

The EM economies have been the darlings of Western investors who seek refugee from domestic zero percent interest rates. Once the U.S. Federal Reserve raises rates then the EM countries will experience a huge outflow of foreign money, which will cause their creditworthiness to degrade, making their bonds riskier. The double problem of the end of the commodities boom and the withdrawal of international investors from EM stock and bond markets will increase the odds that EM bonds will go down in price.

One criteria investment advisors use to pick stocks is a "corporate moat". EM countries tend to have lesser number of companies with corporate moats than developed countries do, unless the company is a monopoly. This increases the chances that a company lacking moats will suffer from reduced profit margins during a crisis, which in turn could to bond credit quality downgrades, making bond prices go lower. If the vast majority of EM debt is "Below Investment Grade" (with the exception of sovereign debt) then why doesn't that parallel with the good nature of low-debt-to-GDP of EM countries? The reason is that even though EM countries in the aggregate have less debt as percentage of GDP but those that are in debt are in worse shape than those who have no debts. The concept that EM countries have less debt is only relevant if one assumed that every company is somehow collectively liable for the debts of other companies. Instead what is relevant is the credit quality of those who actually have significant outstanding debt.
The FT ran an article on 8-12-13 which said "The EM story is based on rapid growth…every single element of that story is no longer true". I have written an article "Commodities Crash Hurts Bonds".

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