The Solari Report

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Equity Markets: Unpacking the Important Risk Issues

with Catherine Austin Fitts

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Good evening. Welcome to The Solari Report. Today is July 2, 2015. I'm Catherine Austin Fitts. I'm delighted you could join me.

We're going to be talking about Equity Markets: Unpacking the Important Risk Issues. This is part of the 2nd Quarter Wrap-Up, but I've created a separate commentary linked from your 2nd Quarter Equity Overview blogpost, and I hope you'll access it as you go along.

We've gotten increasing number of questions put into 'Ask Catherine' about risks in the overall markets and the equity markets, and I thought it would be helpful if I gave everyone a brief overview of risk issues – both in written and audio form – because I think it will help you separate out the different risk issues and think clearly about how to address them, which is very important if we're going to stay in a state of finding opportunities and avoiding risks in clearly a challenging and changing time.

The quote I used for my commentary is from William Shed, "A ship is safe in harbor, but that's not what ships are for."

Of course, investment is meant to be invested, and assets are meant to go to work and build the future for us. I want to talk about investment from that point of view and not from the point of view of the fear. I think more and more we're listening to too much fear porn in too many financial commentators because that's what sells.

I'm addressing risks in the following groups:

1) portfolio risk
2) liquidity

3) diversification
4) investment Strategy
5) specific risk issues
6) ethics

Again, I would encourage you to look at or follow on the commentary because that will help.

Equity Portfolio Risk

Let's talk about several that I categorize in this area. The first is custodian. The most important thing you need to understand is: Who is your custodian, and are they trustworthy? The custodian is the person who really has your money. You could put your money in many places, but it won't necessarily be with the money manager or the initial institution; it's going to be someplace else, primarily with the custodian.

You need to make sure it's large, it's experienced, it's well-capitalized, and ideally their business is serving retail customers. Being a custodian is a core part of their business, and they don't have big investment banking operations, and derivative or other leveraged principle positions would create a significant conflict.

There's an old adage: Never have all your money in one place. That means never have all your money with one custodian.

So custodians are issue number one. Issue number two is governance. You are the governor of your money. You're the chairman of the board. If you're disabled and not capable of doing that, then you need to get a trust officer you can trust to be chairman of the board. That means it's your responsibility to ensure that there is excellence and leadership throughout your portfolio, whether it's the custodians, the managers, the analysts, or the company management. You're responsible to know where your money is and what it's doing or who know that, and you need to know that they're doing a good job of it.

There's an old adage: What you pay attention to grows. That means you need to set up a process and budget time to ensure that you are doing a good job at that. If it's economic for you, you can hire advisors or use subscription services to help you monitor and stay informed about the markets. There is plenty of capacity to help you do that.

Management. You can manage some or all of your equity investments. If you hire other people to do it, you can use investments that involve passive management where things are invested according to certain formulas, or you can use active management by hiring one or more active managers. There are pros and cons to both approaches. Whether you use one or both, again, you still need to govern whether it's active or passive.

Jurisdictions. There are benefits to having your assets in more than one national jurisdiction. The idea is if the US launches a nuclear war with Russia, it would be nice to have assets in the southern hemisphere, not that I think that is going to happen. But given the kind of activity of global securities markets, protecting against those kind of worst case situations is really best addressed with physical assets, whether it's offshore properties, putting all your cash in a depository vault, and not securities. That's not to say that there are not jurisdictions that have better custodian arrangements than the United States; I think there are. But again, all the global securities markets are linked, and in any extreme scenario securities are not what protect you in that case.

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There are benefits to having funds in other legal jurisdictions, including outside of the authority of the United States. Most financial institutions – essentially all financial institutions – are going to respect the US authority with respect to the assets of US citizens. That's an important thing to realize. It's important to understand what you are or are not getting away from.

But there are jurisdictions, as I said, who have excellence in custodians in a superior legal and financial infrastructure. It takes a lot of money and expenses to create mechanisms to move assets to those places. In some situations it's worth it, and in others it's not.

Many of the offshore opportunities I'm asked to review are simply very expensive and fee-heavy ways of getting less reliable custodians in jurisdictions where a foreigner who is a stranger may not fare so well. So beware. There are many offshore solutions that make things worse, not better.

Liquidity

There are two kinds of liquidity that I want to bring up. One is market liquidity. If an asset is liquid and you can buy or sell it quickly without the sale having a material impact on the price, I would consider it liquid. You want to make sure when you look at that that you're looking at it not just when the markets are up and strong but when the markets are under pressure. You want an asset that is going to be liquid when the market is down, not just when the market is up.

A healthy personal balance sheet has a balance between liquid and non-liquid assets. There are a lot of good investments like your home that are not necessarily liquid. If you're in San Francisco right now, your home is probably pretty liquid, but a lot of real estate – certainly where I live – it's not liquid.

To give you an example, I own a foreign REIT which is not particularly liquid. It's traded OTC in the US, and the volume is very light. You have to be careful how and when you sell it. It's yielding 8%. I bought it for the yield, and I feel a lot of confidence in Singapore in the long run, although Singapore is way down. I anticipate holding it for the long term. For that portion of my funds, I'd rather get 8% than have it sitting in a CD getting nothing.

Again, it's not liquid. You just need to be very careful when you buy something that's not liquid. You need to anticipate that and allocate for that within your portfolio.

I see a lot of subscribers and clients approached with numerous non-liquid equity investments which I discourage. You have to be very careful about what you do that is non-liquid.

You should be a high net worth before considering most of these kinds of investments. Alternatively, if you're non-high net worth you should budget a certain portion of your assets for private equity if you want to do it, but be prepared to lose 100% or to lose a great deal to fees and transaction costs.

So liquid assets are generally subject to far more disclosure and sunshine, and there's nothing like having millions of other investors in the open market helping you monitor and using price as a signal. I think that's why you hear so many financial people aggravated by political manipulation and interference with price because price is such an important tool of communication to help us invest.

Generally, I think when it comes to equities, unless it's your own business or a closely held business of someone in your family that you want to back, I would be very careful about what you do that's not liquid. A lot of the non-liquid private equities are really vehicles for fraudsters or people just charging very high fees.

Cash management. I've gotten a lot of questions lately because of the problems in Greece as to whether or not the people's cash management arrangements are safe. Part of this is the turn in the bond market.

For US citizens, the most conservative approach is to keep cash in a trusted depository or safe, or use FDIC insured deposits, or keep cash and cash equivalents such as a US Treasury bill or AAA short-term sovereign bond. Beware of the currency risk if you do anything other than the US Treasury.

Less conservative or government-only market accounts and Treasury ETFs. Please be aware of fear porn on cash management issues because I see a lot of fear and loathing spread around, and then encouraging you to do things that are far less safe than the traditional 'put money in a bank CD'. So I would be very careful before you stray from the traditional lines.

Of course, one of the problems is there's a concern if there are bail-ins that people will get hit. If we are in a world where an FDIC deposit gets taxed, that's a whole new world. We are all subject and our assets are all subject to gross national taxes, given how the US can print currency as long as the US dollar is the reserve currency. It would be insane for them to try to tax deposits as opposed to debase the currency, but clearly if we get into that kind of world we will discuss it separately.

Right now I am not particularly concerned about the cash management issues, at least immediately. It's one of the things that I'll be tracking on my 'Money and Markets'. Again, the three things to do – if you want to be super careful – are to keep cash in a trusted depository or safe, use FDIC insured deposits, or keep cash and cash equivalent such as US Treasury bill or AAA short-term sovereign bond, and make sure that all of those are with safe custodians or trusted depository or safe.

Diversification

If you've not read my post *Beyond Diversification*, I recommend you do so. I've provided a link in the commentary, but it's also on the blog. You can certainly find it by just doing a search for *Beyond Diversification* on the Solari site.

Diversification in your securities portfolio is designed to optimize your securities performance on a risk-adjusted basis. That means it's within the parameters of risk tolerance that you define. The place to start with diversification within your securities portfolio is allocation. The vast majority of your performance comes from having the right allocations at the highest level – which is cash-fixed income equities and commodities.

Within each of these allocations, you have sub-allocations. So for equities, those allocations can be defined in numerous ways. Two of the most important are places and sectors.

Places, as more economies develop and grow stock markets, it's easier globally to access investment opportunities from different countries and a wider selection of countries. Part of it is the percentage of global GDP that is generated from those places is growing, but also a greater percentage of the local economic activities are being securitized into the stock market, and investors are interested in diversifying.

There is now a very broad selection of regional and country ETFs and funds, and it makes it much easier to invest in places.

Sectors relate to the industry groups of investments. For example, sectors can be real estate, utilities, industrial, consumer discretionary, or consumer staples. The popular breakdown of sectors and then individual industry classifications in those are in *Morningstar*, but there is a great deal of investment analysis that describes the investment characteristics of different industry groups and individual industries – both within the industries and how they behave in various business cycles through time.

Technology is also permitting new and very flexible ways of looking at allocations and grouping of companies and trends. For an interesting one, take a look at the new website *Motif Investing*. I put a link up in the commentary.

My vote is in the period of great change and uncertainty you want really broad diversification. Because securities markets are subject to significant central bank management treasury subsidy and intervention, part of insuring that your portfolio is diversified means not highly dependent on specific government or government policy.

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I remember I once reviewed an equity portfolio that had lots of stocks, and they were all stocks that were highly dependent on US government purchases and contracts. It was essentially one big bet on the growth of US government spending and the ability of governments to access government's largess. From a sector standpoint there was zero diversification, and the person whose portfolio it was had no idea.

Investment Strategy

In your investment strategy you need to decide if you want to invest in individual stocks or in baskets of stocks. Baskets means funds, so I'm going to assume for purposes of this conversation that we're not going to talk about hedge fund or leverage funds. We're only going to talk about different kinds of what I call 'no load funds', so we'll talk about mutual funds or closed-end funds or exchange traded funds which are referred to as ETFs. Those funds – or those baskets – can be actively managed or passively managed. Sometimes they're referred to as index funds.

Again, this is part of the decision as to whether you want an active management or a passive management. There are pros and cons to each. The disadvantage of active is they tend to have higher costs and they have minimums, which may be more than you want to invest. They can charge a redemption fee if you exit within the first 90-180 days. For me, that makes them a liquid. So while I'm buying into something that is relatively high – because it's trending up and going higher – I tend to want to avoid subjecting myself to a redemption fee. What if it stops going up?

Seasonal and historical patterns. One of the beauties of the securities markets is they lend themselves to statistical quantifiable analysis. Over long periods of time you can definitely see that there are seasonal patterns, and it pays to know them. For example, you're always hearing me say that the majority of gains in the US stock market occur between November and June. That doesn't mean that there aren't summers when the stock market goes up, but the old adage 'Sell in May and go away' makes some sense.

It's really worth the time to understand the seasonal and historical patterns that relate to your investments. Recognize that they don't always apply, but it's good to know what the odds are.

Value versus trend. Grossly oversimplified value investing means buying stocks when they're cheap – when their PE is low, when their market valued at book is low – and trend means buying when stocks are going up, so you're buying into what has momentum and which can often mean buying at a high PE, which for some of us is highly uncomfortable, particularly if you like value investing.

Some of the challenges are that cheap stocks may have further down to go, so a stock can be very cheap and tempting to buy, but it's always – to me – more attractive to buy when it's hit a bottom and it's starting to go up. Inexpensive stocks can run out of gas.

There are many tools and strategies for monitoring that help you deal with that, things like stop prices or trailing stops, limit prices, option strategies, and it pays to learn those and learn when they're useful and when they're not. They can make things more complicated and more expensive, so you have to use them with care.

Interest rates. Since 1980 we've been living in a period of generally falling interest rates. That has been a bull market in bonds. That is likely to be over. We are likely coming into a period where interest rates are either going to plateau or head up.

Rising interest rates can have a major impact on everyone and everything. Governments cannot continue to borrow cheaply. Mortgages cost more, credit cards cost more, and banks and insurance companies will likely experience rising profits.

Historically the US equity markets can handle rising interest rates up to approximately 150 basis points a year, so that's 1.5%. If interest rates go from 3% to 4.5%, usually the stock market can digest that. The one caveat warning about that is the US market – and the strength of the US market – has been very dependent on US corporations buying back stocks. It's an enormous part of improved earnings per share, and they really have been liquidating part of their capital base to sort-of keep their stocks high.

If interest rates rise, US corporations will not have the kind of ability to borrow cheaply and use that money for stock buybacks. The low interest game has allowed US corporations to very tidily reengineer their balance sheets in a way that kept the stock market afloat. If you remove that game, we don't know what that will do.

When interest rates rise, you want to make sure what stocks and funds are sensitive and perform well in that environment and what don't. For example, stocks that are sensitive to rising interest rates on the down side are utilities and real estate. Sure enough, US real estate has gotten hurt in the second quarter by rising interest rates.

Rising interest rates can be expected to put pressure on bond prices, particularly the long-maturity bonds and lower credit quality bonds. The question, of course, is where would all the money in the bond market go? It can't all go to cash. If the answer is to stocks, then there are going to be more investors seeking dividends, which brings me to my next area of concern under investment strategy, and that is dividends matter a lot, especially in this environment.

Look for companies that have the ability to continue to meet their dividends. They have a relatively inelastic demand for what they do. They've got command of their market share. What they do is important and has value in the future.

The best companies are ones that can continue to grow their dividends. I put up a link to our equity overview on *Dividends Matter* which is very good.

Naked versus hedge. There are numerous ways of hedging a variety of different market risks – interest rate risk, currency risk, and then overall market risk price. You can invest in funds and ETFs that also know how to do it and do it for you. Understanding the options in this area and using them, again, involves more complexity and expense, but it's worth doing if you want to protect yourself against volatility or loss. It's one of the arguments for having an active manager because that's part of what they do.

Creative destruction. I think this is one of the most significant risks and opportunities in the environment. One of the most compelling arguments for broad diversification is that creative destruction is upon us from the global rebalancing of the economy, from new technology, from fiscal and monetary policies, and the shift from Global 2.0 to 3.0, as well as rising interest rates. All these things can cause dramatic change in valuations and sudden gaps in valuations.

I put in the commentary link to our Solari Reports on the shift from Global 2.0 to 3.0, particularly in the 3rd quarter last year I focused on what the areas of opportunity are. I think the 3rd Quarter Wrap Up is particularly helpful.

Earnings announcements. US stock performance is highly dependent on earnings. Of course, global markets, too, but the US market has been quite sensitive. That means you can get meaningful swings when quarterly and annual earnings are announced or earnings expectations change.

Price drops, because they can be so significant, and overreaction can offer opportunities to buy. So I find it's very useful to know which individual companies you'd love to own, and look for an opportunity to jump in and scarf them up. If they get unreasonably hammered by the momentum buyers during an earnings announcement that is disappointed – of course, if you're concerned about potential swings, there are always things you can do with stop prices and options to hedge your positions.

Specific Risk Issues

Number one is debasement and inflation. Rising stock prices may not be an indication of a strong economy or earnings; instead it's the result of inflationary monetary policies. Rising is going to happen with real estate and other real assets or equities. Rising prices may not be the sign of a stronger economy but simply the underlying value of the currency diminishing its currency debasement. It's one of the reasons why it's important to own real assets or equities that are rising during a period like that. Otherwise, your savings is very much debased and diminished if you're holding it in cash.

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I'm saying that at the same time because of the volatility in the markets there's a tremendous advantage to having cash with which to buy when the market you want to take a position in is down. It's a balancing act.

Corrections. Equity markets can be bull markets that are rising or bear markets falling. One of the most important issues is to be able to differentiate between a correction, say a bull market just drops 10-25% as part of its consolidation before rising again – which is very healthy – and a bear market when markets are going down and staying down for an extended period.

Investment performance is significantly enhanced by avoiding bear markets. So the theory that 'buy and hold' is the strongest is really what one ought to do is not one I disagree with. The facts are that modified 'buy and hold' strategies outperform strictly 'buy and hold', and that's pretty easy to prove. At the same time, you have to have a strategy that says beforehand how you're going to manage corrections and how you're going to have to define levels at which you throw in the towel because you've got to decide when you say, "Okay, this may not be a correction. It's a bear market, and I'm out."

So you need to develop this strategy before the time comes, and you need to have methods that you've agreed upon to use it. I would encourage you to think ahead about how you're going to deal with corrections or a switch to the bear market, and how you're going to tell the difference.

The next one I want to talk about is fraudsters. Please don't do business with criminals and psychopaths, even if they are socially prestigious criminals and psychopaths. This should be self-evident. I'm astonished at how it continues to not be self-evident.

I've found that some people are highly attracted to criminals and psychopaths or they are attracted to their social prestige, and that is for many reasons, but it includes the desire to be 'in' and get the inside deals. "I'm in with the in crowd, and they have the inside poop." As you saw in 2008, they don't always have the inside poop. They're part of the C-team that gets sent out to sweep more money into the system.

The other thing is the desire to find something magical. Magic only happens when you don't understand how something works and you're impressed with promises of above-market returns. If something seems magical, then it means you don't understand it. In fact, things that make money aren't magical; they come from business models that work and management that work. A lot of it is good, old-fashioned stuff. If something seems dazzling and magical, you need to dig in a little more.

Finally our media is full of entrainment technology, and this technology is used to manipulate financial decisions including technology that gets used at investment conferences. On the phone I've experienced both of them.

We need to know that that technology exists, and make sure that we're not allowing it to impact our financial decisions. We have an excellent Solari Report called *Entrainment Technology: Subliminal Programming and Financial Manipulation*, and this is an essential risk that we all have to use. If your mind isn't coherent and clear, you cannot govern your life – let alone your assets and equities.

Extreme scenarios. This is another bugaboo of mine. There is no financial solution for extreme political problems such as war or an extreme geophysical event such as the death of the planet. In any scenario in which the securities market collapses and stays collapsed, your securing investments will be lost or worthless and you'll likely be dead. So extreme scenarios are best addressed by your physical provision.

I spend most of my time worrying about how you have what you need when those kinds of things don't happen. I assure you that if the world collapses then I won't be responsible to generate the overhead I need to make sure that everybody on the Solari team is properly taken care of because we'll all be dead.

These scenarios get your adrenaline going, which is why the internet is full of lots of financial fear porn. Some of it is because it gets your adrenaline going; some of it is because the people spreading it are angry for a variety of reasons. I'm not saying that they don't have reason to be angry, but that shouldn't translate into fear that causes you to make poor financial decisions.

So you need to not get distracted from engineering the kinds of tools that give you the power that you need to make sure you and yours are protecting and building wealth now because fear will put you in a place that's going to lose you money more often than not.

Finally, facing uncertainty. The most important aspects of governance, of enforcement, of the economy on planet earth are secret. You and I don't have access to that information. We wish we did, but we don't. I know no financial planner or no investment advisor or no newsletter writer who has access to that information. We're all trying to figure it out, and a lot of us are putting into place different pieces of the jigsaw puzzle. What that means is we don't have the knowledge we need to have to determine the future. That's why I encourage the use of scenario design to help us think through investment strategies and to position assets in a manner that provides for success in all but the most extreme scenarios.

The worst investment strategies that you can have are ones predicated on a set certain view of the world in the future, let alone one based on fear. We don't know what's going to happen. In fact, we need to think in more powerful ways, which is: How are we investing to have it turn out in the ways we want?

One of the things I encourage my clients to do is imagine yourself in 1900. You have radical changes in technology coming, you have multiple wars, numerous totalitarianism regimes that commit genocide on a massive scale, but during the entire century inventors created, entrepreneurs built, real estate developers constructed, bankers did IPOs, people bought and sold stocks, the market went up and down, and great fortunes were made and lost. In one sense, our situation is the same, although clearly the weapons are getting evermore destructive.

I would remind you that through the whole thing, great progress was made. We can make great progress, too, but it's a matter of getting our money invested in things that solve the problems that are before us. The ship needs to sail.

Ethics

One of the important risk issues for a lot of us is spiritual. Where is our money going, and what is it doing in our name? You need to identify and define the ethical screens that you want applied to your portfolio. The more you use baskets, the harder it is to apply those screens. An exception for that is Motif Investing which will allow you to manipulate the specific holdings so you can invest in a motif and then cancel out one or two stocks. Motif Investing is very new. It hasn't been proven as a company or a custodian, so I say that and I would be careful, but I do think you can get a lot of great ideas at their site.

In conclusion, the world is changing and that creates financial risks. But I will say that the majority of those financial risks can be anticipated, they can be understood, and they can be managed. The worst investments come from greed and fear – the greed that leaves the door open for fraudsters, and the fear that causes you to stop investing and hide your money under the bed rather than putting it to work in the creation and building of the economy forward, but there is always a balance in how you do that.

Remember the future is created by the people who build it, not the people who predict that it will not exist. In that spirit, I wish you good hunting.