THOUGHTS FROM THE FRONTLINE

ME

How to Dodge the Debt Train

By John Mauldin | July 20, 2018

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Standing in front of a speeding train is rarely a good idea, but most investors are doing it right now. They survive only because the debt train is still way down the tracks. It is nonetheless coming, and you will want to move before then. But which way?

Over the last two months I made the case (summarized here) for a coming worldwide debt default/restructuring/financial engineering. Call it whatever you want but it won't be good.

While I think we have a few years, I see little chance we can escape some kind of painful reckoning which I believe will culminate towards the middle to the end of 2020s. The opportunities to change course are behind us now. Yes, there are things many countries can do to put things back on track, but most are not politically possible in this fractured world. It will require a crisis to muster the political will to fix this.

While we can't do anything about that—and the people who can do something are choosing not to—we *can* take steps to protect ourselves and maybe even profit from this approaching train crash. Many of you have asked for specific advice. I'm somewhat limited in what I can say, both for legal reasons and because we have readers in many different situations. Not everything is suitable for everyone. But I can give you some general ideas and rules to follow. Today, we will start with the smallest investors and then move on up.

Some of my Mauldin Economics colleagues also have ideas, which I hope you read in the special reports we've featured in the last few days. More on that below. But now, let's consider how to dodge the train. I have four rules to follow, all of which would be good practice even if we weren't in front of a speeding train.

Rule #1: Get Active

Remember when fund managers were Masters of the Universe? Few qualify these days, and not because they are any less talented. It is because the last decade's generally rising markets favored passive "buy and hold" investment strategies. Why pay a manager when you can get great results for lower cost—nearly free for some index ETFs?

I've never been a buy and hold fan. I am aware of the Nobel laureates who say it's the only way to succeed in the long run. They're right about the numbers—but I think wrong about human nature. Any investment strategy works only as long as you stick with it. Telling people to throw their money in stocks and not worry when a bear market chops it in half does them no favors. Most will panic and sell at exactly the wrong time. Every advisor/broker has seen it happen.

Ideally, you would pair your passive indexing strategy with an advisor who keeps you from making rash decisions. The problem there is advisors can only do so much. It's still your money and they have to pull it out of the market if you say so. Furthermore, advisors have to get paid somehow, which reduces the cost savings that justified passive investing in the first place.

That doesn't mean advisors are useless—a good one can save your bacon. But it should be someone philosophically aligned with you and in whom you can place enormous trust. They aren't easy to find. The largest investors in family offices generally have a team of people giving them advice.

An active manager worth his or her salt will manage risk as part of the deal, and risk management is exactly what you need when you live on a railroad track. It doesn't have to be perfect, just good enough to mitigate the major drawdowns. If everybody else loses 40% and you only lose 25%, you'll be way ahead of the crowd. And the right manager should avoid even that scenario and keep you near break-even.

Some Advice for Small Investors and Those Starting Out

A brief pause before we go on to Rule #2. If you are early in your investing career or still consider yourself small, the most important things you can do are:

1. Simplify your lifestyle and save more money. That's not particularly fun, but in the long-term will pay huge dividends.

2. Get out of debt. Do not carry debt on credit cards. Pay your credit cards off as quickly as possible. Saving is easier when you aren't paying 18% interest. You're not going to get 18% on your investments.

3. There are a whole host of options for how to save. For small investors, there is not much magic. Some of you are going to roll your eyes, but I suggest reading some books by my good friend Suze Orman, or (if you have a more religious bent) Dave Ramsey.

4. Move as much money as possible into tax deferred accounts. Taxes are the #1 killer of investment returns (more on this below).

   Where to invest? Now I'm going to talk out of both sides of my mouth. For smaller accounts, use low-cost index funds or ETFs. But consistent with my philosophy, you do not want to buy and hold forever. You need some kind of risk management rule. If nothing else, use the web to run a 200-day moving average on whatever index funds you choose. Check once a week and if your fund goes below the moving average, then rotate into a short-term Treasury fund. Jump back in when it crosses above.

   Market timing is extraordinarily difficult. There is no perfect system. I have spent 30 years looking at money management systems from some of the greatest traders in the world. All of them will have problems from time to time.

   We'll discuss this more in future letters, but you get the general idea.

Rule #2: Use Multiple Tools

The problem with active managers is none of them are perfect. That's not a reason to avoid them; it is a reason to use *several* of them covering different strategies and asset classes. Assembling the right combination takes some skill, though. It does you no good to have three managers who make and lose money at the same time. You succeed only in creating more paperwork. They need to be uncorrelated.

Further, an "active manager" who never goes to cash is not really active, at least from my viewpoint. He is simply a stock picker whose portfolio will get crushed in a bear market. I can give you literally hundreds of examples. Look at the portfolios of some of the great stock pickers in the last 20–30 years. Then see what happened during bear markets. It was ugly.

Multiple managers are the core of my personal strategy. I have money allocated to several different managers who use it to trade ETFs. In other words, they're *actively* trading a *passive* portfolio. I think this is an ideal combination. You know what the ETFs' components are, and you know (or at least think you know) whether they are in favor at the moment. If so, you want to own them and avoid them if not. The key is having the ability to adjust quickly.

I also am a strong believer in quantitative systems rather than human discretion. Do not, and I mean do not ever, give your money to gun slingers who "have a feel for the market." They will lose their feel right after you invest your money. Trust me.

Also in my portfolio are multiple private hedge funds whose managers use more sophisticated techniques that you can't do with ETFs. Their edge is the ability to move quickly and quietly. Look beyond the common long/short equity strategies. There are all sorts of interesting markets available. As I've written in the past, the "alpha" in long/short equity has evaporated where passive investors simply buy everything. Even the dogs go up. It's very frustrating for a value investor, which I consider myself to be. Our time will come but for now let's do something else.

Having said all that, I should note I do have some long-term, buy-and-hold investments—mostly small-cap biotechnology stocks that I think have a good chance of achieving a moon shot. They would be hard to sell quickly even if I wanted to, but I'm fortunately able to hold them without too much worry. They are bonuses, not critical to reaching my financial goals. I'll be disappointed if they should drop to zero value but it won't affect my family or lifestyle.

And frankly, the world will be better off if we find a cure for cancer or can reverse aging. In my own small way, I'm trying to own investments that do some good.

Rule #3: Sell Liquidity

This one takes a little more explanation. If we see a serious possibility of a global debt default, then it seems obvious you don't want to be a lender. But in reality, it's practically impossible *not* to. Even stashing your money in a bank is technically a loan; your savings account is a liability on the bank's balance sheet.

Or maybe you avoid corporate bonds and buy equities… but you might still be an indirect lender, if the company, say, leases equipment or real estate to other parties. Those are a form of debt.

The only way not to lend your assets to someone else is to invest in physical, storable property. Gold is an obvious candidate and I think it's a good idea to own some. But I also wouldn't go whole-hog into precious metals. What else can you do?

The answer is to keep lending, but be smart about it.

Maybe you can't avoid lending or predict whether a debt jubilee will annihilate your principal. You can, however, make sure that you earn yields that compensate you for the risk. And the best way to do that is to sell liquidity.

The nice thing about bank accounts, money market funds, and Treasury bills is you can always trade them for something else, with no notice. They are highly *liquid*, in other words. But we forget that liquidity isn't free. You "pay" for it by receiving lower yield on those assets.

This can make sense if you really do need that money available instantly, but that's often not the case. People leave cash in money market funds for months and even years, earning much less than they could by simply buying a three-month CD and rolling it over. There's no significant difference in credit or interest rate risk. It is simply a lost opportunity—a gift you hand to other parties.

Obviously, you want *some* liquidity because things happen, but most investors want too much of it and it cuts deeply into their returns. With very little effort and almost no extra risk, you can enhance your return on cash by 100-200 basis points (that's 1-2%) annually, just by accepting lower liquidity on money you don't need to keep liquid anyway.

You might do even better. In the private credit world I've written about (see The Seven Fat Years of ZIRP), it's possible to earn 300-600 extra basis points in additional yield. Those opportunities are legally accessible only to high-net-worth investors, unfortunately, but they are worth investigating if you qualify.

Rule # 4: Get Radical on Taxes

I've quoted Woody Brock's prediction that the unfunded government liability problem will get solved with a wealth tax. Even if he's wrong, I think the era of lower tax rates on wealthy people is drawing to a close. We had a good thirty years or so, but this most recent tax cut may have been the peak.

However, higher tax *rates* don't necessarily mean you pay higher taxes. We'll just have to get more creative in the business and lifestyle changes we're willing to make, within what the law allows. I am aggressively exploring some options I would not have considered even a year or two ago.

Federal, state, and local taxes take a big chunk of my gross income. And, to the extent I receive government services, I'm happy to pay for them. I am not happy to pay for the follies and extravagance of politicians who have little interest in the public good and want mainly to line their own pockets.

I'll have more to say about my own adjustments after I make a few decisions, some of which won't be easy. I mention it now because it may benefit you to do the same: consider moves that you previously rejected. Times are changing and we have to change with them.

For instance, there are ways to use life insurance to defer your taxes. And there are very low cost annuities (as in $20 a month) in which you can control the investment and defer your capital gains until you sell. It's just as liquid as a bank account, but tax-deferred.

If you own a small, privately-held business without many employees, consider setting up your own defined benefit plan. You can control the investments and place a lot more money into the plan than with a traditional IRA or 401(k). I know people with several of these.

Next week we will cover more options available to wealthier investors. But the basics apply to everybody, including me.

Vision Week

You should have received emails recently about our biggest-ever **free** event for readers, *Bull or Bust: Navigating the High-Speed Train Wreck*. We've been posting some special reports that fit right in with what I've discussed in this series.

Unfortunately, if you missed my emails, two of the three special reports for investors are no longer available. (We are talking about making them available in the future, but they will not be free).

But you can still read the third Vision Week report, *Capturing the Upside: What the Mauldin Editors Are Currently Bullish On*.

Read this free report now

I should point out that this report will come down early Sunday, so if you can, carve out a little time today to read it.

And please watch your inboxes over the coming week. We've got some fascinating presentations and guidance coming your way from Jared Dillian, Robert Ross, Kevin Brekke, and Patrick Cox.

If my "Train Wreck" series has you concerned about the future (and my inbox tells me it does), you won't want to miss them.

Puerto Rico, Maine, and Beaver Creek

Shane and I are visiting some friends in Puerto Rico this weekend. Then, of course, I have the annual Maine economic/fishing conference and a few weeks later, a board meeting for Ashford, Inc. at the Beaver Creek Park Hyatt which the company owns. If you are in Puerto Rico or Beaver Creek, drop me a line and maybe we can get together.

Making the Hard Choices

Writing this series and my book has made me reflect a great deal on my own personal finances and the future. Frankly, I need to take some of my own advice. Physician, heal thyself.

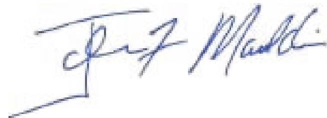
I like my lifestyle. Life has been good to me. But I can't say that I'm conservative or (gods forbid) frugal. I will be 69 in about two months. I always assume that I can work forever, but I know that's not really realistic. So I'm going to have to make some changes in my lifestyle. While they may not be easy, I believe the cultural shifts I foresee over the next decade make them necessary.

They are mostly in the planning stages and I have not really pulled the trigger, but I can assure you that I have made a commitment to take my own advice. None of it is bad. I've just realized I can structure things a lot more efficiently, and I should do it today rather than wait until the changes get forced upon me.

Shane and I actually look at these changes as an adventure… something a little different for a Texas country boy and girl. I will write about them more specifically in the future as we make the decisions.

It is time to hit the send button. You have a great week. Take some time this summer to begin making *your* plans.

Your maybe-get-a-little-sun analyst,



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