THE JAMES ALTUCHER REPORT

EVERYTHING YOU NEED TO KNOW ABOUT THE STOCK MARKET CRASH AND INVESTING

First off, I have to tell you two stories.

One: On December 13, 2008, pretty much one of the worst weeks in market history, my publisher decided that should be the launch date of a book I wrote.

The book was called “The Forever Portfolio” and it was about the stocks I felt that people should buy and hold forever.

Nobody bought the book. That’s not true. At last count, 299 people bought the book.

Nobody wanted to hear about buying stocks forever. People were selling stocks and not looking back.

I was scared also. I had started a new hedge fund in September 2009. But the hedge fund that funded me got too scared and decided at the end of October to stop the experiment.

I really thought all aspects of my career were over. Plus, I had recently sold a company for all stock and that stock had gone from $13 to $7 and I had just bought a home (against all of my later advice).

So what happened? The guys at Choose Yourself Media did an analysis the stocks in the Forever Portfolio have gone up 191% and the stocks in the Dow Jones Market Average have gone up 80%. In the past 5 years I have (luckily I have to admit) outperformed the market (and Warren Buffett) by 22%.

I don’t say this to brag. I got lucky. I was so scared I couldn’t sleep. I would go on the Erin Burnett Show on CNBC every Tuesday and during the half hour I was on the show the Dow would go down another 500 points. Every week. I thought I was going to throw up all the time.

Second story: Fidelity used to ask me to give talks to their clients four times a year. Sometimes more.

IN THIS ISSUE:

That February (2010), I was going through a divorce, I was still scared, and I had just gotten fired from the company that bought my prior company. So I had no income and no prospects in sight.

About 500 people were in the audience. I'm sure some of the readers of this newsletter were there.

I outlined all the reasons the market was going to go up. First, in the back office, I told all the Fidelity professionals why I thought the market was going to go up. One woman literally started crying and said, "thank you. Even if you are dead wrong I need some hope." Fortunately I was not wrong.

OH! I have a third story.

I forget the exact day. It was a year or two later. Maybe 2011. July 5th or 6th. I was debating Nouriel Roubini. He said the market was going to go 20-50% down from that point.

I said it was going to go straight up.

Again, I got lucky. It went straight up.

This sounds like I'm bragging (I guess I am a little) but I do a lot of research. An enormous amount of research. It's my family's livelihood at stake because I make my living by investing. I don't make it off fees or scams or going on TV or books. I invest.

But I'm a bit lucky. Because a lot of people do research. What I'm going to do is summarize some of my research by going through my process from A to Z.

Since these are bullet points and we are limited to about a billion or so words here this list might not be totally comprehensive, but maybe we can figure out a way (perhaps on a podcast) that I can answer any additional questions you might have afterwards.

By the way, a top Director at the Swiss bank, Credit Suisse, wrote to Nouriel Roubini about a year after our debate and said: "Looks like James was right. When are you going to invite him to one of your famous parties."

Roubini was well-known for having blow-out parties. I didn't want to go anyway (I'm more of a cave-man) but I was curious what his response would be.

He did write back, to his credit, and said: "Next time there is a recession."

Well, we're all still waiting.

HERE YOU GO, THE A THROUGH Z OF WHAT YOU NEED TO KNOW ABOUT THE RECENT MARKET CRASH.

A. Since 1955, if the market is down for six months, it's on average positive one year later.

I don't like statistics like this because there are too few examples. Suffice to say, we've been here before, we'll be here again, and usually the market is higher a year later.

B. The market is down, in part, because of fears that China's economy is falling.

China has grown 10% per year for 30 years. Now it's growing about 5%.

A couple of points. That's GROWTH of 5%, even though it's slowing.

Also, much of their growth was funded by our bonds, which they have been consistently paying back BE-CAUSE of their growth. And a lot of their growth has come from building first-world products that our innovation has developed.

They are the second-largest economy in the world. But let's not forget: in 1989, Japan was the second-largest country in the world. That was the highest Japan ever was. Meanwhile, we keep growing. The U.S. has been the source of innovation for both Japan and China.

But what if China fails?

OK, so what? Here's what EVERYONE has failed to mention in the newspapers: China represents less than 1% of U.S. exports. China could go to zero (and, one again, they are growing), and we'd still have a growing economy in the U.S.

C. THE FED

I put it in caps so you say it out loud ominously. People are afraid the Federal Reserve will raise interest rates.

How come? The Federal Reserve interest rates are (very roughly) the interest rate they charge banks. The lower they are, the less banks pay on savings accounts.

So if the Fed raises rates, savings accounts rates go up and people would rather invest in a safe savings account than the high-risk stock market.

OH MAN!

The Fed Funds Rate is 0.25%. I have to put an exclamation point in there. 0.25%!

Do you think if they raise it to 0.5%, or even 1%, suddenly everyone is going to say, "Man, I better move all my money into a savings account now.

Of course not! In fact, the Fed only raises rates when the economy is going strong, employment is strong and inflation is starting to peak up (which is not happening).

So typically, for at least the first year after the Fed raises rates, often the Stock Market goes UP, not down. And in a case like this, where rates are so low, it will take a long time before the Fed has rates at 6% or 7% where it starts to compete with the average market returns.

I actually hope the Fed raises rates although I think that is not likely given that I am more worried about DEFLATION than inflation right now.

D. P/E ratios

Readers of this newsletter are at all different levels of financial literacy and that's fine. When I was building my first business I could care less what a P/E ratio was.

Basically, if a company is worth $100 but its owners only take $1 a year home in income, then the P/E ratio is said to be 100. That's very high and it's where almost all the Internet stocks were in 2000 when they collapsed.

That's also 1% of what the company is worth. That's where I'd rather look at savings accounts or bonds.

So a P/E ratio of 100 is bad (1% return) and a P/E ratio of 5 (20% return with Federal Interest rates at 0.25%) is too low. Usually the market is around 15-20, particularly with Federal Interest rates so low.

The stock market's P/E ratio on average is 19 right now, which is high but not excessive.

BUT, market indices are weighted in favor of the larger companies so we should really be focused on those.

The P/E ratio of:

- Apple is 12
- Exxon …12
- Wal-Mart…13
- Berkshire Hathaway (Warren Buffett)…18

These are the companies that should tell you if the market is high or low.

How come? Because if the market is lower is Apple going to really trade low enough to give out a 20% dividend? That would be almost impossible. And there is no sign that the growth in these companies is slowing.

Which brings me to:

E. **When the entire market goes down 10-15% does that really mean 8,000 companies should simultaneously lose 15% of their value? This is why I am always suspicious of media-driven market selloffs.**

For instance, Disney, which is about to release the first Star Wars movies in a decade or so, just lost $32 BILLION in value in the past five days.

Really? Is it going to lose another $32 billion and then release Star Wars, which will be the biggest movie in box office history?

F. **I know a lot of people are panicking but we have to have a little perspective.**

The market has "crashed" and "reeled" according to the headlines at the Wall Street Journal, which I used to write for.

Guess what. It's down 3% in the past year. 3% is not a crash. That's what's called a normal market where stocks go up and down.

And it's UP about 18% in the past two years. That's about average. Maybe slightly above average.

This is neither good news nor bad news (which is the point). It's not even news. The market might go lower. But it has not been anything close to a crash and is only called that to scare you.

G. **Warren Buffett likes markets like this (I wrote the book "Trade Like Warren Buffett"). Why?**

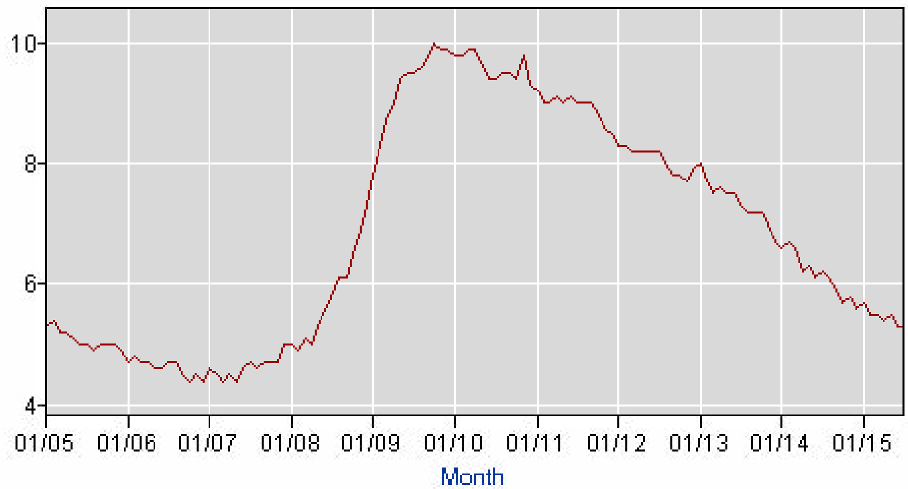
As he puts it: When you go to the grocery store you aren't hoping that hamburger prices are high. You are hoping they are low.

Unless, of course, capitalism is falling apart (which it didn't even do when it looked like it was in 2008).

When stocks are low, chances are they go up from here. Even in the worst part of the 2008-2009 crash, guess what happened – just a few years later the market was back to all-time highs.

H. Unemployment

When people are employed, they buy more, companies do better, and stocks go up.



Looks like people have jobs to go to.

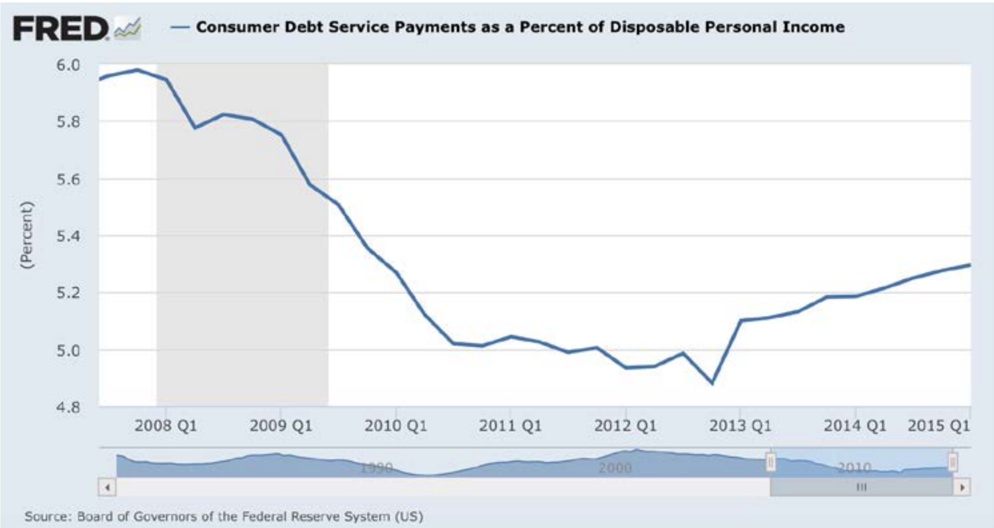
Now, you can argue, look at 2007. They had jobs to go to then and then we had the biggest crash since the Great Depression.

Which is why another number is important.

People can't buy things if they owe a lot of money.

I. Household Debt Obligations

This is the ratio of how much of people's income goes straight into paying debts. Here it is, straight from the Fed:



Guess what? More people are employed and we owe less money. Hey kids, buy those crappy clothes at Forever 21 in the mall!

J. Fear

Check out this quote by Howard Ruff, who regularly appears on CNBC and warns about all the doom and gloom about to happen.

This is from his book, "How to Prosper from the Coming Bad Years"

"*Much of the American wealth is an illusion which is being secretly gnawed away and much of it will be completely wiped out in the near future. . . . So what is the rest of your future? A grisly list of unpleasant events—exploding inflation, price controls, erosion of your savings (eventually to nothing), a collapse of private as well as government pension programs, and eventually an international monetary holocaust which will sweep all paper currencies down the drain and turn the world upside down.*"

Sounds pretty scary! Heck, I'm scared reading it.

It was written in 1979. Right before a two-decade (even a three-and-a-half-decade, if you count recent all-time highs in the market and economy).

Why did he write this? Because he wanted to scare you.

Here's what he wrote a few years after that quote:

"I lost my subscribers at the rate of 25 percent a year, by far the lowest attrition rate in the industry, but the sure road to failure, given the inexorable math and the nature of time, while some of my tougher and more savvy competitors are still in business with varying degrees of success, and some of them are very rich now. My wealth became barely a shadow of what it once was. As the list of followers shrank, so did the sales of the other products and services I offered them that I was counting on, until in the year 2002, my list had shrunk to only about 3,000 faithful followers. And how about my glorious Mapleton mansion? I lost it to foreclosure..."

Fear will only get you so far.

K. OIL

Another thing people are afraid of now is that oil is so low.

There's a cliché: We need to learn history or we will repeat our mistakes.

Unfortunately, even knowing history, we tend to repeat mistakes.

Oil was a massive reason the stock market hit its third worst period in in the past century, in 1973-74 when the OPEC crisis hit.

It's because Oil was going UP and not down. And OPEC was holding us hostage so we had no idea how high oil was going to go. It was crushing the economy.

Oil at LOW prices is not necessarily a bad thing.

That said, the fears are going to be over. How do I know? Because I invest in oil wells. Meaning I know guys working on the rigs who tell me what happens.

I spoke to a guy who recently went out wildcatting on his own wells who used to be a very high executive at Exxon. He schooled me on Oil.

He said, "James, everyone gets their data from the EIA. The Energy Information Association. We're all supposed to report how many wells we have drilling. Well, we delay. Between four months and two years. And that's the data the media gets."

"The reality," he said, "is that oil wells are shutting left and right. They are all shutting down at these prices."

"So does that mean oil companies are a buy?"

"Maybe," he said, "but the U.S. also gets oil from elsewhere. Better to buy a company like Apache Resources which has huge investments in natural gas which is also a byproduct of all of these oil wells."

L. HOGS

I want to tell you a story about fear. In 2009, the World Health Organization issued a pandemic alert on Swine Flu. I don't want to discount the importance of this. Over 200,000 people died. This is a far cry from the 18 million who died in the 1918 flu pandemic, but every life is important.

That's not why I'm telling this story. I did a video the day of the alert. How come?

Because a stock with the symbol HOGS fell 20% in one day. They were (or are, who cares) China's biggest pork packager.

Guess what? (I say that a lot but only because the gap between news and reality gets funnier and funnier): You can't get swine flu by eating pork products.

There was no reason for this company to lose 20% of it value in ONE DAY. It went back up almost immediately.

I am not judging fear as good or bad. And, by the way, I am not recommending people go out and buy the market.

The lesson to be learned from all this is to:

- **A.** Not panic
- **B.** Begin to look for opportunities when people are behaving irrationally

The market is going to crash much worse than this at some point. If you have an arsenal of good stocks and opportunities that are well-researched then you won't even waste your time looking at stock prices day to day.

That's the beauty of good research. That's why I've started thinking about stocks again. Because opportunities like this are starting to happen.

Not short term HOGS-style trades (although those will always be there and I will try to keep people informed of them).

But long-term trades based on the ever-increasing American innovation, which can't be stopped.

Which brings me to:

M. TRENDS

In 2008 the main trend that was happening in the economy was that people were taking out massive mortgages to buy houses and banks were not ready to handle defaults. They had horrible balance sheets. More on that later because it wasn't as bad as people said.

But now the trends are so much more diverse and the opportunities are so much greater.

Robotics, Drones, 3D Printing, Synthetic Biology, etc are all growing at rates of 100-300% PER YEAR.

That might mean they are small now. But in four or five years you could be 3D printing your driverless car and using a typewriter to type out the DNA for a new prosthetic leg that lets you run 60 miles an hour like the Six Million Dollar Man.

There are a couple of high-flying stocks (e.g. stocks with the words "3D printing" in them) that I wouldn't touch. But there are 100s of companies that are the suppliers of the main flagships of these trends.

Again, I'm never in favor of buying the market. Not because I think there's massive crashes. I just don't really enjoy watching the ups and downs and having to research all of the idiotic issues in play.

But I love looking at the back doors of these innovative technologies and finding the right plays. They might not work out tomorrow, just like stocks like Amazon and Apple weren't straight up lines. But they will be huge as the opportunities become apparent.

Don't forget the important rule: If you start with a penny and double it every day, in four days you only have 8 pennies. But in 30 days you have $10.7 million.

This is what happens in explosive industries. The first industry that experienced this growth was technology when Moore's Law in the 60s predicted that chip power would double every year.

Well, he was right. And now everything is run by computers. Your smartphone is a billion times more powerful than the computers on Apollo 11, which went to the moon.

N. Housing

The culprit! The bane of 2008!

Housing fell apart in the last crisis. In fact, housing fell apart in 2006, a full two years before the market fell apart.

So what is happening to housing now, which is a major part of the U.S. economy?

Last month sales of existing homes reached the highest levels since 2009.

Sales of new homes were also up 10% year over year. And with household debt obligations at a low (see above), this industry is not in danger of default. Far from it.

O. The Banking System

Part of the problem in 2008-9 was that the banks technically collapsed. Only a change in the laws plus a massive bailout saved them.

But on several metrics, banks are at their healthiest levels ever:

- chargeoffs (debt that is written off)
- capital in the bank
  (cash on hand if there is ever a run on the banks, although this is a very rough definition)
- number of banks failing the stress tests put in place are at the lowest level since crisis

So banks aren't failing.

P. The Reason for the Crash of 2009

Right now we are feeling post-traumatic stress over 2009. I am, for instance. When the market goes down 10% I call my best friend and ask if the world is over. I can't help it. It's like a reflex.

But then I start thinking again.

A lot of bad things were happening in 2007-8. Don't forget that the housing boom ended in 2006, so this wasn't the real reason for the crash.

What happened that caused the crash?

This is hard to explain but it's important.

If I owe a bank $100, the bank puts $100 as an asset on its balance sheet. It plans on getting that $100 back from me. If I miss a payment, it still has it at $100.

This may or may not be the correct thing to do. Maybe they should mark it down a little.

But for 100 years they didn't.

Then in late 2007 (the peak of the market was November 2007) the Financial Accounting Standards Board changed the rules.

They basically said, "banks have to mark debt where the last price was."

Imagine if your house is worth $500,000. Your next-door neighbor dies and his kids are desperate to sell the house so they sell it for $300,000.

According to the new law in 2007, you would have to "mark" your house at $500,000.

Hedge funds were aware of this and began selling the debt, forcing banks that held similar debt to mark them down because of the new rule, even if there were no defaults (yet).

So banks were no longer meeting the minimal required standards and started to fail. One thing led to another and we didn't have a housing crisis (which was in 2006), we had a financial crisis (2008-9). Hedge funds made billions. Main Street went bankrupt.

Guess when they changed the rule back: Early March 2009. The day the market started going straight up again until it hit all-time highs.

I'm not saying this is the only reason for what happened. A lot of bad things were happening and, to be fair, banks were over-leveraged (which they aren't now).

But still, when you change the rules without taking into account what could happen, a crash could happen, which did happen until the situation was reversed.

Nothing like this is remotely happening now. A healthy capitalist system depends on healthy banks. Healthy banks eventually lend to companies doing innovation and that builds new industries and economies go up.

Again, it might not mean the market goes up or down. It just means, don't panic. Look for your spots. Some sectors will crash, some will go up.

We're going to experience a lot of ups and downs just like we just did. I don't say this to scare anyone. Just to get ready for it. I will tell you what I like to do. I don't always do it but I try.

Q. Don't Do Anything

I don't even look at the newspaper. I watch comedies. Lately I've been catching up on "The Jim Gaffigan Show." He's in his first season and it's very funny. I can't wait to see him live on December 12 at Madison Square Garden.

When markets go down 10%, some of my smaller stocks go down 30%. I don't think of it (well, I do a little. I get scared). But the reality is: If the story hasn't changed, the stock is just going along with market volatility.

R. Use 2-3% of Your Portfolio

When I buy a stock, I only use 2-3% of my portfolio. This gives me room to maneuver when the stock goes down and I can buy more. I've bought more shares of TROV for instance when it went down once.

I believe in the long-term stories of every stock recommended here. And that strategy has served me well and made me a lot of money in the past five years.

But it's hard not to panic. I basically research my way out of the panic. I admit it.

S. I Diversify by Hedge Fund

I admit I'm not the smartest guy on the block. The smartest guys have 100 PhDs working for them and people visiting factories in other countries and writing down the license plate numbers in parking lots and so on.

The hedge funds.

So what I do is keep track of their filings and their movements. Watch what stocks they buy, wait for the stocks to dip, and then it's as if the hedge fund is working for me. I get a better price, I get total nimbleness, and I get to pick the best of their picks.

Example: If Warren Buffett buys IBM at $120 and it goes to $100, well I'm fine taking Warren Buffett's free advice, buying it at a discount to where he buys it, and then riding it out since he's a long-term holder.

Interesting report: If you JUST piggyback Warren's picks (and not wait for a discount), even then you would've outperformed the stock market by about 10% per year.

T. I Don't Day Trade

A situation like HOGS is a very rare example. There are a few other rare examples like that but you have to really be watching for them.

When you day trade you turn the stock market into a zero-sum game. There are winners and losers.

You're on one side and I always imagine Vladimir Putin and the top hedge funds on the other side. They are going to win.

Often if a stock goes down people trigger panic. They call me and ask, "are you selling?" and I always ask, "did the story change?" and they say "no, but the stock is down."

Fine, if the story hasn't changed and nobody is breaking the law with insider trading (which does happen but you can tell often and avoid it) then I might even buy more.

U. The Role of Quant Hedge Funds in the Crash

A good friend of mine is the head of all wealth management at the largest Swiss bank.

I called him up. What's going on?

He said, "This is the result of default triggers that are being set off at every quant hedge fund. They were up a certain amount for the year, when it falls below a certain number, they sell everything so as to preserve their fees just in case this is a mega-crash."

So, much of the crash was created by automatic triggers worried there would be…a crash.

Hedge funds manage over a trillion dollars of money. When they are all piling over each other like little kids trying to escape. Bad things happen.

But once the rush is over they look around and say, "What did we just do?" And just as quickly they try to get back in.

Normal humans aren't worried about taking home $10,000,000 bonuses.

Well, I thought I had up to "Z" but the stock market as a whole is not that interesting. STOCKS are interesting to me.

It's worth noting that these stocks all started in depressions or recessions:

- IBM
- Southwest Airlines
- General Motors
- FedEx
- United Technologies
- Microsoft
- Hewlett-Packard
- Symantec
- Intel

So even in a recession, you can find opportunities that can create billions in value for early shareholders.