The INVESTMENT LETTER

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KISS… Keeping your Investments Simple and Safe

Warren Buffet once said, "Investing is simple... but it's not easy." Investment Counsel stands for transparency in its communications and investment strategies. If we cannot explain an investment to you in simple English, we won't support it. Investment Counsel subscribes to the KISS philosophy, which we define as Keep your Investments Simple and Safe. We purposely keep our communications, operations, and strategies simple. We are happiest when you fully and comfortably understand your portfolio.

There are as many ways to invest your money as there are to lose it. To be the right investment for you, an investment has to be right for you right now. Not next year. Not in ten years, and not five years ago. That said, some complex investments are good portfolio choices for some people, but if you don't happen to fit into their narrow target market, they are not the right investment for you.

Complex investments are sometimes new-to-market, offer tax benefits, and often do not move with the stock market. Their relatively higher risk can translate into greater returns … or losses. These characteristics attract the interest of many investors, including those who might have achieved the results promised by these complex investments simply by investing in their more conventional counterparts.

Complex investments are inherently … complex! They sometimes require specialized knowledge and expertise, and often lack the liquidity of conventional investments. They may have higher fees and exhibit more volatility. Most complex investments, lacking long histories, have not been time-tested and their reaction to market stresses may be theorized and not firmly known. Due to their nature, they are also the breeding grounds for investment scams.

What are some examples of these complex investment products? How are they defined?

In 2012, the International Organization of Securities Commissions (IOSCO) defined a complex investment as "a financial product whose terms are not likely to be understood by an average retail investor, where the product has a complex structure, is difficult to value without specific skills/systems and/or has a very limited or no secondary market and is therefore potentially illiquid." Complex investment products could include high-yield bonds, notes with principal protection, or products that incorporate futures and options. In this newsletter, we examine three complex investment products that have caught the attention of the mainstream press.

Complex Investment Product #1: Universal Life Insurance

Universal Life insurance, popular in the 1980s and 1990s, combines the peace of mind that comes with life insurance with the promise of a return from an integrated savings account. The basic premise is that the interest earned on its savings account pays the future costs of the policy and defrays eventual increases in policy premiums.

Universal Life, as a product, worked well when interest rates were high enough to support its underlying assumptions. As interest rates swung lower, however, and as its policyholders aged, the cost to insure those lives could no longer be borne by a low interest rate environment. Many of those policyholders, now in their 80s and 90s, must pay thousands of dollars to keep their policies in force.

Decades ago, these policyholders trusted the insurers and agents who sold these policies and many did not fully investigate and/or understand the implications of holding these policies long-term. As a result, many policyholders have now paid more in premiums than their beneficiaries will someday receive.

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Complex Investment Product #2: Hedge Funds

Hedge funds promise to help investors mitigate risk in challenging times, and have increasingly attracted skittish investors as markets have turned more volatile this year. Hedge funds promise a safer haven for investors, and often claim that they can thrive in both bear and bull markets because, unlike mutual funds, they can bet against individual companies, as well as on bonds, currencies, and the likelihood that corporate mergers will come to pass.

Do they deliver? Not always. According to the HFRX Global Hedge Fund Index (which tracks hedge fund performance), hedge funds have underperformed every major bond and stock asset class during this past decade – and that includes our last bear market. More recently, in October, while US stocks suffered their worst month since 2011, the HFRX showed that October hit hedge funds just as hard. Only 25% finished the month in the black.

Also, hedge funds tend to be actively managed, which means higher expense ratios for hedge fund managers, whose fees often follow the "two and twenty" compensation structure, meaning that their clients pay a 2% flat fee on total asset value and then pay 20% more for any excess profits that are earned on a portfolio. For comparison, Investment Counsel charges 1% or less on total asset value. However, despite underperformance and higher fees, hedge funds are still growing, reaching $3.2 trillion at year-end 2017.

Complex Investment Product #3: Cryptocurrency

The general concept of cryptocurrency isn't that hard to grasp: digital money that you can exchange for goods and services just like physical currencies. In 2010, if you bought a bitcoin, the most well-known cryptocurrency, you would have paid … about two bits – 25 cents. By December 2017, that same bitcoin would have be worth approximately $20,000. Those types of returns generate excitement, press … and risk. From that peak, the price of a bitcoin has fallen precipitously – to below $4,000. Like everything, your gains or losses in cryptocurrency depend entirely on when you entered the market.

The world of cryptocurrencies is new, fastly-evolving, and highly unregulated. One study last summer estimated that some 2,000 cryptocurrencies like bitcoin exist on the market, and that nearly 40% of them are now valued at less than a penny. Complicating cryptocurrency's growth is a lack of acceptance among merchants and in financial markets. Additionally, the lack of regulation that contributed to their growth is threatened as regulatory authorities continue to seek ways to further regulate cryptocurrencies.

Parting Words of Advice

FINRA, the Financial Industry Regulatory Authority, recommends that you compare relative risk with relative return when you consider new investments, as well as product costs and fundamentals.

We also recommend asking about the product's liquidity, and how the product correlates with your other investments.

Investment Counsel will always be here to listen to and answer your questions, and to help guide you toward the realization of your long-term investment goals and objectives. Any decision about the inclusion of investments into your portfolio needs to consider your goals, your risk appetite, and your liquidity needs. We embrace the simplicity of Warren Buffet's investment advice, so much so that we put it on our website. It pervades everything we do and every interaction we have with you. We are transparent in the advice we provide to you, and we seek that same transparency in the investments we recommend for your portfolios, investments that have stood the test of time, and that can be explained easily over a cup of coffee. ■

Investment Counsel News

Everyone at Investment Counsel wishes you and your family a happy, healthy and joyous holiday season and a very prosperous 2019!