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Do you remember x-ray glasses? In the good old days, they would advertise x-ray glasses in comic books or on the back of cereal boxes with a picture showing a boy wearing these glasses and looking at the back of his hand and, amazingly enough, the boy in the advertisement is able to see the bones in his hand.

For those of us who saved up and sent away for these glasses in the mail, you know how this worked. After what seemed like months of waiting, the glasses finally came in the mail and you ripped open the package and put the glasses on and tested them out. And just like the boy in the advertisement, you looked through the x-ray glasses at the back of your hand and what did you see? The skeletal outline of the bones of your hand! Imagining the possibilities, you looked at the nearest wall to see if you could see though to the other side of the wall and what did you see when you looked at the wall? That's right, the bones of a hand. Because inside the lens of the "x-ray" glasses were etched the image of the bones of a hand.

It was a total gimmick. And you were crushed to learn there is no such thing as x-ray glasses. But for those who bought these things, it was an important life lesson wasn't it? The lesson being, some things in life are too good to be true.

And it's an important lesson for investing specifically: there are some things in the financial world that can be too good to be true. We see a lot of theories, adages, computer programs, fancy algorithms and financial products that, for us, sometimes appear too good to be true. In this newsletter we want to discuss a couple financial products that, to us, have the quality of appearing too good to be true. Those products are fixed indexed annuities and alternative investments.

As a disclaimer, we are not necessarily saying these products may or may not have a place in a person's financial situation, we just think it's important to be realistic about these touted solutions, and especially consider the downside potential if things don't work out like an investor hoped, and finds his or herself invested in something that turned out too good to be true.

Let's start with fixed indexed annuities.

Fixed Indexed Annuities: Too good to be true? The general premise of a fixed indexed annuity (FIA) is you are guaranteed not to lose money while at the same time participating in the growth of the stock market if the stock market goes up. While there are a lot of things to consider when investing in FIAs, not the least of which are the surrender charges and commissions often associated with these products, we think it is important to highlight a specific aspect of how these products work.

Insurance companies utilize derivatives to help make good on the promises they've made with the FIA[(1)]. What is a derivative? A derivative is a contract between two or more parties with a price dependent upon or derived from an underlying asset[(2)]. Derivatives are often traded with borrowed money and leverage. In other words, derivatives, as we see it, are speculative investment vehicles that when used well can hedge risk, but when used poorly can blow things up.

Remember the financial crisis of 2008? A lot of the meltdown in the financial markets had to do with derivatives. From our perspective, the comfort and safety promoted with FIAs may not be all it is cracked up to be when you consider the nature of the investments used by the insurance companies to make good on the promises they make with these products. If your tax preparer, brother-in-law, or neighbor who just got in the financial business, is recommending one of these products to you, we'd be more than happy to sit down and go over the product with you. As we already mentioned, there is a lot to consider with FIAs. We only mention the derivatives aspect because in our experience insurance agents who sell these products often don't discuss, let alone understand, the derivatives aspect of these products.

Alternative Investments: an alternative investment is basically anything besides stocks, bonds or cash[(3)]. Alternative investments could be managed futures, derivatives, real estate investment trusts, aircraft leasing, commodities, you name it. With all the uncertainty in today's financial markets, we see alternative investments being promoted as something to help protect investors in the next downturn. However, we are not so sure alternative investments will save you when you need saving--especially alternative investments that are illiquid and highly leveraged.

As with all financial products, there is a lot to consider before investing in alternative investments (like what the risks and fees are, etc.). In the current market environment, there is one consideration we think is especially important to zero in on—liquidity. Liquidity, as we are using the term here, means there will be a buyer when the owner wants to sell.

There has been a lot of liquidity moving around in the markets as central banks have flooded the financial markets with printed money in the form of quantitative easing. But this factor is changing, especially in the U.S. as the Federal Reserve is raising rates and looking to raise rates further. We are moving in a direction where there is less and less liquidity in the financial system.

The lack of liquidity can pose a risk to alternative investments. As Maike Currie writes in the *Financial Tim*es, "The common thread with all of these assets is liquidity risk. Investors are lured by the promise of yield and apparent low volatility but they ignore the fact that none of these assets transact easily." Curie also reminds us that "It is a lack of liquidity that drives drawdowns—not volatility" [(4)].

Can you get out in an emergency? These assets are not traded on an exchange like stocks and bonds are. You need to find a buyer. According to Currie, this is one of the biggest dangers of alternative investments. In other words, investors who are buying alternative investments in an attempt to protect themselves in a down market may find these assets may not come through for investors when they need them to come through. These investments may not work precisely when investors need them to work due to a lack of liquidity.

We are obviously making some very generalizing comments about a very complex topic, but suffice to say we feel liquidity, or lack thereof, should be a forefront consideration for those considering purchasing alternative investments. This is not meant to serve as a recommendation one way or the other. But consider it a word of caution next time you have a conversation with someone suggesting alternative investments as a potential financial solution.

Europe: A Special Update

As this newsletter was going to press, Deutsche Bank was making headlines. This was not a surprise to us. For readers of our newsletters and those who have heard us speak at seminars recently, you know we have been talking about troubles in the European financial sector for a while now and have had major hesitations about investing overseas. While we may finally be seeing (from our perspective) some opportunities beginning to open up in foreign investment markets, we think it's worth addressing the situation with Deutsche Bank.

It’s just been bad news after bad news for Deutsche Bank. Among their challenges[5]:

- They are heavily exposed to the fracking industry in the United States. Fracking continues to struggle due to today’s low oil prices.
- At 54.7 trillion dollars, Deutsche Bank has the largest derivatives exposure of any bank in the world.
- The US Justice Department just fined them 5 billion dollars for fraud in mortgage security sales. (Though we are hearing reports this is already being renegotiated.)
- Deutsche Bank itself is only worth 16 billion dollars.

No wonder their stock price is down almost 90% from its all-time high in 2007 and down 60% from a year ago August!

In addition, of the major banks in the world, they are the riskiest from the standpoint of only having capital that is 2.68% of its assets (a healthy bank has 10%). It’s not just Deutsche Bank. Banks in Europe are in trouble. There are a whole host of European banks right behind Deutsche Bank with no one even close to the healthy level of 10%. Here is where it all ties together for us. Right now there is a nuclear time bomb of credit default swaps (largely mortgage derivatives) of around $550 trillion dollars in the world with European banks owning a good chunk of those types of derivatives. This has the makings for a real mess.

We are watching this situation very closely for implications it could have for our client portfolios.

We believe avoiding the major crashes and losses to wealth is critical, but we also believe the second part of an effective investment strategy is to be able to invest and purchase assets at what could be a screaming deal after a downturn. These are the two keys to investing in our opinion—avoiding major losses and buying after a downturn. The hard part is you can’t have one without the other. Successful investing in our opinion means managing both sides (up and down) of the market. If you get wiped out in a crash, you don’t have the “dry powder” (like cash or other liquid assets) to buy things at potentially bargain prices. Things have been trending sideways in the market with some significant bumps along the way but we haven’t had a major downturn in a while, which is why we think it is prudent to stay cautious. We are not recommending sitting this market out as of yet, but we think it makes sense to be both psychologically prepared and strategically prepared to respond to changing market conditions.

We continue to believe that what investors need most is not a magic asset or investment, but a good strategy. If you would like to discuss your strategy with us or have accounts you would like help managing, please give us a call to set up a time to discuss your situation.

Sincerely,

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Notes:
(1) "Index Annuities Obscure Fees as Sellers Earn Trip to Disney", Zeke Faux and Margaret Collins, *Bloomberg*, January 19, 2011.
(2) Definition of derivatives from *Investopedia.*
(3) Definition of alternative investments from *Investopedia*.
(4) "The liquidity risk of alternative investments", *Financial Times,* Maike Currie, August 7, 2015
(5) "How Deutsche Bank Could Take Down Germany", *Economy and Markets,* Harry Dent, Sept. 30, 2016.