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Don’t Blow Yourself Up

There’s a long list of investment strategies and products that may look good on paper but can create significant risk. Making matters worse, they are accessible to nearly anyone with a brokerage account.
Back in 2002, Warren Buffett famously warned the world that derivatives were “financial weapons of mass destruction”. He wrote that derivatives carried dangers that, while laid dormant at the time, could be potentially lethal. It only took a few years for his premonition to come true, as these financial contracts blew up during the depths of the financial crisis in 2008.

Derivatives are incredibly complex financial products that most investors will never encounter. However, not all financial weapons are fancy products created by investment banks. There are others that are available to anyone with a brokerage account. Let’s discuss five of them and why they should be avoided.

**Margin Lending**

Margin lending enables an investor to invest more than what they have in their account. For example, if an investor had $100,000 in a trading account but wanted to invest $120,000 into the stock market, brokers will create a margin account and lend $20,000. The appeal is that you can use someone else’s money to invest. It’s like using a mortgage to buy a house. Put down $100,000 on a $500,000 house, sell five years later for $600,000, and you doubled your initial investment. Well, not exactly because of taxes and loan costs, but conceptually this is how it works because you borrowed most of the money.

But margin lending is a really bad idea for three reasons. First, leverage goes both ways. Let’s say that house sold for $400,000 instead. The bank is going to want its money back, so after you pay back the loan, your equity is wiped out.

Second, the interest rates charged on these loans are relatively high and can eat into returns. For example, TD Ameritrade charges between 7.5% - 9.5% based on the size of the loan. That means your “hurdle rate,” or the return required to break even, is whatever you’re paying to borrow from your broker.

Third, margin loans use investors’ existing stock portfolios as collateral. If stocks begin to sell off for whatever reason, then the value of the collateral falls, which may trigger a “margin call.” Investors are then required to put up more collateral or pay back the loan. If they don’t, their broker will force liquidate their portfolio to recoup the loan balance. I’ve lost count of the number of investors I’ve met who were up big only to end up broke in a matter of days because a levered position turned on them so fast that they didn’t even have time to react.

**Going Short**

When you are “long” a stock, the most you can lose is what you invest. But if the price soars higher, there’s theoretically unlimited upside, which is the whole point of investing for the long run. However, the situation is reversed when you bet on the price of a stock falling. There’s limited upside and unlimited downside. Even a relatively small “short position” can create tremendous risk if the stock price were to soar higher.

This asymmetry can often fuel a “short squeeze.” This happens when a heavily shorted stock receives unexpected positive news. That’s not good for someone who is exposed to unlimited downside, and it can quickly ignite panic buying (the opposite of panic selling) as short sellers cover their positions. The ones who can’t get out first get squeezed as the stock soars higher.

Shorting stocks is also expensive. Brokers charge a fee called the “borrow” to facilitate short sales. The borrow is based on supply and demand and changes daily. Heavily shorted stocks or those that trade infrequently can easily exceed 50% annually. Meaning, a stock would have to fall
more than 50% over the course of a year to yield a positive return for the short seller.

Short sellers are integral to markets, but leave it to the professionals. The requisite skill and ability to manage risk are traits that are often too hard to acquire on your own.

**Stop Loss Orders**

A “stop loss” is designed to limit an investor’s loss on a position by instructing a broker to sell at a specified price. For example, if an investor bought a stock at $50 with a stop loss at $40, the stock would be sold at the next price after hitting $40. Capping a potential loss sounds great on paper, but there are three issues with them.

First, stop losses don’t guarantee execution at a specified price. Once a stop loss is triggered, the order is entered as a “market order,” which executes immediately at the best available price. This feature risks locking in big losses during panic or if news came out after the market close that caused a stock to fall below the stop loss once the market opened again.

Second, there’s little justification for capping a loss on an investment simply because the price crosses a line in the sand. The day-to-day movements in stock prices are almost always emotionally driven, which often have little to do with the fundamentals that drive the long-term price. Think of all the times that a stock fell 10% or more because of an overreaction to news, only to recover in a matter of days.

Third, professional traders love to take advantage of stop losses. Known as "stop hunting," traders short stocks already in decline to try to push prices lower in an attempt to trigger a flood of stop-loss orders. Once triggered, these same traders will start buying to profit from an expected rebound. Meaning, you could get stopped out of a position for no reason other than predatory trading practices.

**Levered ETFs**

An Exchange Traded Fund (ETF) is a marketable security that tracks an index or a basket of stocks, bonds, and/or commodities. The fund owns the underlying assets and then divides ownership of those assets into shares, which are then traded on stock exchanges.

Levered ETFs use debt to amplify the returns of whatever index or asset class they aim to track. Most of these products are designed to double or even triple the exposure. For example, a triple-leveraged S&P 500 ETF will return three times the daily performance of the index.

But levered ETFs are meant to only be held for a day and often become unreliable if held longer. Let’s say that a stock index that starts at $100 falls by 20% on the first day to $80, rallies by 20% on the second day to $96, and then falls by 25% on the third day to end at $72 for a net loss of 28% from the original price of $100.

A triple-leveraged ETF tracking the same index would fall by 60% on the first day to $40, rise by 60% on the second day to $64, and drop by 75% on the third day all the way down to $16 for a three-day loss of 84% from the original price of $100.

The problem is that while the index would have to rise by 39% to get an investor back to even, the levered ETF would have to rally by a staggering 525%. Meaning, declines can have a devastating effect on the long-term performance of these products. Unless the index or asset class they track rises forever, it is virtually impossible for levered ETFs to track properly.

**Currency Trading**
The foreign exchange market (forex) is the largest financial market in the world, with over $5 trillion traded each day. This market is dominated by large banks, corporations, and investment funds to speculate and hedge exposure to various currencies.

Over the last two decades, online trading tools have democratized access to the forex market. Individual investors can now buy and sell from all over the world with a click of a button in the comfort of their own home. And since the forex market is open 24 hours a day and five days a week, it is arguably more convenient to trade currencies than stocks.

But these advancements and ease of use have done nothing to improve the odds of success. According to the National Futures Association, roughly 72% of individual investors lose money in the forex market, and I’m actually shocked this number isn’t higher for three reasons.

First, the leverage permitted is mind-boggling. Since currencies don’t move that much on a daily basis, regulations in the U.S. allow leverage of 50 to 1 for individual investors. In other countries, it can get as high as 500 to 1. Meaning, if $1,000 is deposited into a forex trading account, an investor could trade up to $50,000 by borrowing the other $49,000. As explained, leverage amplifies outcomes, and bad losses can wipe out an investor in a matter of minutes when levered this high.

Second, forex brokers are not your ally. They know that most traders lose money, so they often take the other side of a trade. As a result, when an investor loses money trading, the dealer can win on the trade and charge a commission for beating you.

Third, there is effectively zero regulation. Forex is the Wild West and manipulation is rampant. Not to mention, you’re going up against professionals at huge institutions whose size and skill are insurmountable hurdles for most individual investors.

The Bottom Line

I wish this list was exhaustive and there were no other creative ways to risk detonating financial goals. But that’s just not the case. There are so many others out there. The good news is that most really bad ideas share the same DNA, so here are three suggestions to help steer clear of them.

The first is leverage is not your friend. It is the enemy of all that is good in investing and should never be employed. Save debt for other assets like cars and homes where you feel comfortable making the payments and the lender won’t issue margin calls.
Second, always read the instruction manual and don’t jump into any investment product unless you and/or your financial advisor have a thorough understanding of how it works. For example, the United States Oil Fund (ticker: USO) attempts to track the daily price movements of U.S. crude oil. The name alone suggests that this is what it’s designed to do. However, USO doesn’t actually own any oil, which is a big reason why the chart below shows that it’s done an abysmal job at tracking the price of oil.

Third, avoid anything that attempts to speed up the process. Investing is supposed to be boring and uneventful. Avoid market timing and any strategy that you would feel compelled to brag to friends about at a party.

The bottom line is that most financial weapons of mass destruction hide in plain sight. Look for warning signs and avoid anything that seems too good to be true.

Sincerely,

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Sources

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